

# **Suitability Requirements With Respect To the Distribution of Complex Financial Products**

## **Final Report**



**THE BOARD  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES  
COMMISSIONS**

<b>FR01/13</b>	<b>JANUARY 2013</b>
----------------	---------------------

Copies of publications are available from:

The International Organization of Securities Commissions website [www.iosco.org](http://www.iosco.org)

© *International Organization of Securities Commissions 2012. All rights reserved. Brief excerpts may be reproduced or translated provided the source is stated.*

## **Contents**

<b>Chapter</b>	<b>Page</b>
<b>Executive Summary</b>	<b>1</b>
<b>1 Background</b>	<b>3</b>
<b>1.1 Introduction</b>	<b>3</b>
<b>1.2 Past Work in this Area: The Joint Forum</b>	<b>3</b>
<b>1.3 Scope and Focus on Complex Financial</b>	<b>4</b>
<b>1.4 Developing this Report</b>	<b>5</b>
<b>2 Glossary</b>	<b>5</b>
<b>3 Brief overview of existing suitability requirements</b>	<b>7</b>
<b>4 Purpose of the principles</b>	<b>8</b>
<b>5 IOSCO Principles on Suitability Requirements with respect to the Distribution of Complex Financial Products</b>	<b>9</b>
<b>Annex 1</b>	<b>21</b>
<b>Enclosure I            List of respondents</b>	<b>27</b>
<b>Annex 2</b>	<b>28</b>

# **SUITABILITY REQUIREMENTS WITH RESPECT TO THE DISTRIBUTION OF COMPLEX FINANCIAL PRODUCTS**

## **FINAL REPORT**

### **Executive Summary**

In February 2012, the IOSCO Technical Committee published a Consultation Report, entitled *Suitability Requirements with respect to the Distribution of Complex Financial Products* (the Consultation Report). The purpose of the Consultation Report was to discuss possible principles focusing on customer protections, including suitability and disclosure requirements, relating to the distribution by intermediaries of complex financial products to retail and non-retail customers based on a review of members' existing regulatory frameworks, as well as the lessons learned from the financial crisis and relevant actions taken in response.

This Final Report includes the following key principles relating to suitability requirements with respect to the distribution of complex financial products, taking into account the public comments to the Consultation report:

#### ➤ *Classification of customers*

***Principle 1: Intermediaries should be required to adopt and apply appropriate policies and procedures to distinguish between retail and non-retail customers when distributing complex financial products. The classification of customers should be based on a reasonable assessment of the customer concerned, taking into account the complexity and riskiness of different products. The regulator should consider providing guidance to intermediaries in relation to customer classification.***

#### ➤ *General duties irrespective of customer classification*

***Principle 2: Irrespective of the classification of a customer as retail or non-retail, intermediaries should be required to act honestly, fairly and professionally and take reasonable steps to manage or mitigate conflicts of interest through implementing appropriate procedures in the distribution of complex financial products, and where there exists a potential risk of damage to the customer's interest, the intermediaries should, where appropriate, be required to clearly disclose the risk.***

#### ➤ *Disclosure requirements*

***Principle 3: Customers should receive or have access to material information to evaluate the features, costs and risks of the complex financial product. Any information communicated by intermediaries to their customers regarding a complex financial product should be communicated in a fair, comprehensible and balanced manner.***

- *Protection of customers for non-advisory services*

***Principle 4: When an intermediary sells a complex financial product on an unsolicited basis (no management, advice or recommendation), the regulatory system should provide for adequate means to protect customers from associated risks.***

- *Suitability protections for advisory services (including portfolio management)*

***Principle 5: Whenever an intermediary recommends the purchase of a particular complex financial product, including where the intermediary advises or otherwise exercises investment management discretion, the intermediary should be required to take reasonable steps to ensure that recommendations, advice or decisions to trade on behalf of such customer are based upon a reasonable assessment that the structure and risk-reward profile of the financial product is consistent with such customer's experience, knowledge, investment objectives, risk appetite and capacity for loss.***

***Principle 6: An intermediary should have sufficient information in order to have a reasonable basis for any recommendation, advice or exercise of investment discretion made to a customer in connection with the distribution of a complex financial product.***

- *Compliance function and internal suitability policies and procedures*

***Principle 7: Intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability requirements, including when developing or selecting new complex financial products for customers.***

- *Incentives*

***Principle 8: Intermediaries should be required to develop and apply appropriate incentive policies designed to ensure that only suitable complex financial products are recommended to customers.***

- *Enforcement*

***Principle 9: Regulators should supervise and examine intermediaries on a regular and ongoing basis to help ensure firm compliance with suitability and other customer protection requirements relating to the distribution of complex financial products. The competent authority should take enforcement actions, as appropriate. Regulators should consider the value of making enforcement actions public in order to protect customers and enhance market integrity.***

## 1. Background

### 1.1 Introduction

The global financial crisis, which arose in 2008, made clear that the growing complexity of financial products might make the associated investment risks less apparent to customers. Furthermore, questions have been raised about the extent of intermediaries' responsibility for assessing the suitability of structured investment products, particularly in light of the collapse of Lehman Brothers in mid-September 2008. That failure resulted in significant losses by customers in some jurisdictions who had purchased, among other products, Lehman "mini-bonds"<sup>1</sup>. These Lehman mini-bonds" were sold in a number of Asian and European jurisdictions.

In light of the financial crisis, and following the G20's call for action to review business conduct rules<sup>2</sup>, in June 2009, the then IOSCO Technical Committee (TC, now referred to as the IOSCO Board) approved a project specification mandating Committee 3 on Regulation of Market Intermediaries to review the suitability requirements relating to intermediaries' distribution of complex financial products to customers (i.e., standards for intermediaries to assess whether a particular product matches the investment knowledge, experience, objectives and risk tolerance of a customer).

In January 2011, the TC approved a revised project specification to also include how jurisdictions generally apply customer protections, including suitability rules, to non-retail customers. The TC wanted to analyze suitability issues arising out of, and in connection with, the 2008 market turmoil since previous IOSCO work on, e.g., point of sale disclosure, focused on disclosure related issues, rather than the issue of "know-your-customer" and suitability.

In September 2009, the TC published the final report on *Unregulated Financial Markets and Products* (TC Report), which was drafted by its Task Force on Unregulated Financial Markets and Products (Task Force). The TC Report contains recommendations for regulatory action designed to improve confidence in the securitization process and the market for credit default swaps (CDS). The TC Report recommends, *inter alia*, to "review suitability requirements as well as the definition of sophisticated customer and strengthen these requirements, as appropriate, in the context of the relevant market".

### 1.2 Past Work in this Area: The Joint Forum

In 2008, the Joint Forum - of which IOSCO is a Parent Committee - completed a project and report that provided an in-depth analysis of customer suitability in the retail sale of financial products and services.<sup>3</sup> This Final Report is intended to complement the Joint Forum's work.

---

<sup>1</sup> The Lehman mini-bonds were not plain vanilla bonds, but rather complex structured derivative products linked to Lehman Brothers and issued with small denominations, in order to make them affordable to retail investors.

<sup>2</sup> At the G20 meeting held in Washington, D.C. on November 15, 2008, the Heads of State set forth a number of common principles for reform of financial markets that intertwined with IOSCO's current and prospective work. The key points include the promotion of financial markets integrity by, *inter alia*, encouraging "a review of business conduct rules to protect markets and customers".

<sup>3</sup> *Customer suitability in the retail sale of financial products and services*, The Joint Forum, April 2008, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD268.pdf>

The Joint Forum's report provided an overview of how supervisors and regulated firms across the banking, securities and insurance sectors address the risks posed by mis-selling of retail financial products, including related regulatory requirements. An important part of the Joint Forum's work was to survey some 90 financial firms around the world as to how they deal with customer suitability, and manage the risks posed by mis-selling. The project sought information on how suitability requirements applied to complex instruments such as (but not limited to) options, hedge funds, variable insurance products, direct participation programs/limited partnerships and real estate investment trusts ("REITs"), but did not focus exclusively on that topic. The Report was essentially a fact-finding effort; and was issued in 2008, i.e., prior to the financial crisis.

### ***1.3 Scope and Focus on Complex Financial Products***

The focus of this report (Report) and its principles is the application of suitability and related disclosure requirements to intermediaries (as defined in the IOSCO Principles and Methodology<sup>4</sup>) in connection with their sale of complex financial products to retail and non-retail customers (as defined in individual jurisdictions). Conversely, this report does not extend to non-intermediaries, such as producers or issuers of complex financial products acting in their capacity as issuers of such products.<sup>5</sup>

The term "distribution" is intended to have a broad and functional meaning. This is in order to cover the services of selling by the intermediary in its role as such including selling, advising, recommending and managing discretionary accounts / individual portfolios, which results in holdings by customers of complex financial products.

"Complex financial products" are broadly defined for the purposes of this Report. Although greater product complexity does not necessarily equate to greater product risk, there are a number of reasons for focusing on complex financial products. As evidenced by the financial crisis, the level of complexity and opaqueness of a financial product's terms and/or structure will affect the ease with which the risk/reward profile attached to the product may be understood by potential customers. Further, risks posed by certain complex financial products arise from the fact that there may be multiple counterparties to the transaction; and this fact may not be readily apparent or well understood by potential customers. Moreover, anecdotal evidence in some jurisdictions suggests that under certain circumstances, intermediaries may provide incentives to their sales representatives to sell complex financial products that may not be suitable for their customers. In addition, recent experience also suggests that regulatory strategies that rely heavily on disclosure,

---

<sup>4</sup> As stated in the IOSCO Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation (Oct. 2011), "*Market intermediaries generally include those who are in the business of managing individual portfolios, executing orders and dealing in, or distributing, securities.*" According to the methodology, a jurisdiction may also choose to regulate as a market intermediary an entity that simply provides advice regarding the value of securities or the advisability of investing in, purchasing or selling securities. However, for purposes of this report, the term intermediary in the U.S. securities sector refers to registered swap dealers and broker-dealers, not investment advisers.

<sup>5</sup> In general, the IOSCO Committee on Issuer Accounting, Audit and Disclosure (Committee 1) has jurisdiction within IOSCO for the disclosure obligations of non-intermediary issuers.

without consideration of the sophistication of the customer<sup>6</sup> and/or suitability of the product, may not achieve satisfactory outcomes in terms of customer protection, especially where complex financial products are sold. Finally, in contrast to more traditional or plain vanilla products, the complexity of these products may make it difficult for both intermediaries and investors to value them with a high degree of confidence. At a minimum, substantial technical skills and sophisticated computer models are essential in order to seek to value the products, particularly when there is a very limited (or no) secondary market.

### ***1.4 Developing this Report***

C3 surveyed members regarding current regulatory frameworks with respect to conduct of business rules aimed at ensuring that complex financial products are suitable or appropriate to a particular customer. The survey included the review of the current criteria applied domestically to classify customers, products and their risks in the assessment of suitability, and management oversight of the sales process. The survey focused on requirements relating to suitability determinations in the members' regulatory frameworks with respect to retail and non-retail customers. It also elicited information regarding whether certain (or all) complex financial products are considered to be generally not suitable/appropriate for certain customers.

C3 also surveyed members regarding required intermediary disclosures to customers, retail and non-retail, regarding the distribution of complex financial products. The survey elicited information on the extent to which disclosure requirements in the distribution of complex financial products may differ between different types of services or with respect to non-retail customers as opposed to retail customers. Finally, C3 provided a survey to industry associations in order to solicit their views on suitability requirements and also to obtain information from them regarding their practices in implementing suitability requirements in connection with the distribution of complex financial products.

In February 2012 IOSCO published the consultation report "*Suitability Requirements with respect to the Distribution of Complex Financial Products*". On the basis of the feedback received, IOSCO published this Final Report. The feedback statement is included as Annex I to this Report.

## **2. Glossary**

For the purpose of this Report the relevant terms are defined as follows:

- **"Complex financial products"** refer to financial products, whose terms, features and risks are not reasonably likely to be understood by a retail customer (as that term is defined in individual jurisdictions) because of their complex structure (as opposed to more traditional or plain vanilla investment instruments), and which are also difficult to value (i.e., their valuations require specific skills and/or systems, particularly when there is a very limited or no secondary market)<sup>7</sup>. The term generally includes, but is not necessarily limited to,

---

<sup>6</sup> While the term "customer" is used in this Report, it should be noted that many types of complex financial products often have "counterparty." Accordingly, where the term customer is used in this report, the term is also deemed to refer to "counterparties," as appropriate.

<sup>7</sup> Some of these complex financial products may be listed on an exchange, but nonetheless may be seldom traded and thus less liquid. Indeed, although the admission to trading of the product on an exchange may imply that it



structured instruments, credit linked notes, hybrid instruments, equity-linked instruments and instruments whose potential pay-off is linked to market parameters, asset-backed securities (“ABSs”), mortgage-backed securities (“MBSs”), collateralized debt securities, and other financial derivative instruments (including credit default swaps and covered warrants). The term does not include conventional equities, conventional bonds, plain vanilla unit trusts and mutual funds and exchange-traded standardized derivatives contracts. The list is intended to be illustrative and non-exhaustive. The above criteria should be taken into account when determining the level of complexity of a financial product.

- **“Disclosure”** refers to any standard or requirement for an intermediary to disclose information to the customer that could be material to the investment decision (including information on risks and costs). In a sense, disclosure is intended to assist the customer in making his/her decision, but is distinct from the requirement for a firm to make a determination of whether a particular product is suitable for the customer.
- **“Distribution”** covers in broad terms the services of selling by the intermediary including marketing, selling, advising, recommending and, where relevant, managing discretionary accounts / individual portfolios, which results in holdings by customers of complex financial products.
- **“Intermediary”**<sup>8</sup> means a firm in the business of managing individual portfolios, providing investment advice, executing orders on behalf of third parties, dealing in or distributing securities (including carrying derivatives positions)<sup>9</sup>. In jurisdictions where banks are permitted to provide investment services, this term includes banks to the extent they are providing such services.
- **“Suitability requirements” or “suitability”** include any standard or requirement with which an intermediary is required or expected to comply in the distribution of financial products – including as mentioned in the provision of investment advice, individual portfolio management, or in offering for sale both with and without providing a recommendation - to assess whether the product being sold matches the customer's financial situation and needs.<sup>10</sup> An assessment of the customer's financial situation and needs may include an assessment of the customer's investment knowledge, experience, investment objectives, risk tolerance (including risk of loss of capital), time horizon and/or capacity to make regular contributions and meet extra collateral requirements, and understanding of the product in question where appropriate. Suitability is intended to have a functional and all-encompassing meaning, in order to accommodate technical legal terms adopted in different jurisdictions. The intent is to cover broadly various requirements applicable to intermediaries in individual jurisdictions depending on the type of distribution (i.e.,

---

can be sold if desired, listing on an exchange cannot guarantee that there will not be large spreads or infrequent trading, thus making liquidation more difficult and time consuming. It should also be noted that the valuation of complex financial products is done through the use of sophisticated models, which are generally not used by the retail public.

<sup>8</sup> See footnote 4 supra.

<sup>9</sup> The definition includes firms such as product providers who are also intermediaries, and which directly distribute complex financial products they produce. The term does not include issuers who are not intermediaries.

<sup>10</sup> However, Principles 4, 5 and 6 differentiate obligations of intermediaries for: (a) unsolicited sales (made without recommendations) or (b) sales made on the basis of a recommendation.

requirements applicable where there is investment advice, individual portfolio management, other investment services, etc.) and/or type of customer (e.g., retail, institutional, sophisticated, and professional, etc.) and/or type of complex financial product<sup>11</sup>.

### **3. Brief overview of existing suitability requirements**

Suitability requirements generally aim at ensuring that intermediaries only make suitable recommendations and that customers have the necessary expertise, knowledge and financial capacity to trade in financial instruments and to understand associated risks given their investment objectives. Suitability requirements reflect the general duty to act fairly, honestly, professionally and in accordance with the best interests of the customer<sup>12</sup>.

Broadly, it appears from the survey of regulators that individual national suitability regimes incorporate the following elements:

- (i) Conduct of business rules including, e.g., obligations to gather information on products and customers, as well as to warn customers where appropriate that certain products may be unsuitable for them. In addition, some jurisdictions prohibit or restrict the recommendation of unsuitable complex financial products to retail customers;
- (ii) Internal control rules, including recordkeeping obligations, internal policies and procedures related to the implementation of suitability requirements; and
- (iii) Enforcement actions, including both civil and administrative related to breaches of fiduciary/regulatory/contractual duties. In some jurisdictions, there may be criminal liability for such violations.

In most of the surveyed jurisdictions, suitability requirements applicable to complex financial products are the same as those applicable to other securities.<sup>13</sup>

Suitability requirements generally apply when a recommendation or advice is given, or discretionary services are provided. An intermediary is generally permitted to sell a product to a customer, even if it could be potentially unsuitable, as long as it does not provide a recommendation or advice regarding the investment.

In some jurisdictions, with regard to non-retail customers, suitability requirements may be less stringent or inapplicable, through waiver or otherwise. Such non-retail customers may include regulated/licensed entities and, depending on the particular jurisdiction, certain individuals and companies or other legal entities that have a minimum net worth or demonstrated investment experience. That said, in some jurisdictions the manner in which suitability requirements are

---

<sup>11</sup> For instance, as far as European countries are concerned, reference to suitability should be read to include the concepts of suitability (for investment advice and portfolio management) and appropriateness (for other, non-advised, services) under Article 19 of Directive 2004/39/EC (“MiFID”).

<sup>12</sup> The words “in accordance with the best interests of the client” suggest the application of a fiduciary standard. However, in some common law jurisdictions, certain intermediaries may be subject to the duty to act fairly, honestly and in good faith, while not being subject to a fiduciary standard of care. Moreover, it would not be expected that an intermediary would necessarily act consistent with the best interests of its counterparty, even though counterparties are considered customers for purposes of this report.

<sup>13</sup> However, as noted below, in some jurisdictions, the application of suitability requirements may vary, depending upon the customer’s particular characteristics.

applied in connection with the distribution of complex financial products may be unclear. As a result, following the financial crisis, some IOSCO jurisdictions issued special guidance or recommendations that specify how general suitability rules should be applied to certain complex financial products.

Finally, if an intermediary or its affiliate manufactures a product itself, it may have an increased incentive to sell that product in order to generate revenues. This risk may be particularly high during a crisis period, where firms may face difficulties in raising capital from the public and alternative sources of revenues may not be available.

#### **4. Purpose of the principles**

Over 20 years ago, the IOSCO Presidents' Committee approved a Report on International Conduct of Business Principles and called upon all of its members, in a related resolution, to recognize these principles as expressing basic standards of business conduct for financial firms. These principles addressed intermediary obligations of honesty and fairness, due diligence, the provision of information by and for customers and the management of conflicts of interest. According to principle 4: *"A firm should seek from its customers information about their financial situation, investment experience and investment objectives relevant to the services to be provided"*. The comment specifies that: *"This principle is a necessary element in enabling the firm to fulfill any suitability requirements"*.<sup>14</sup>

A similar standard is reflected in Principle 31 of the IOSCO Objectives and Principles of Securities Regulation and relevant Methodology, according to which: *"A market intermediary should obtain and retain from its clients any information about their circumstances and investment objectives relevant to the services to be provided"*; and *"Where the activities of an intermediary extend to giving specific advice, the advice should be given upon an understanding of the needs and circumstances of the customer."*<sup>15</sup> These principles and their implementation have particular relevance in relation to the distribution of complex financial products. Although complex financial products may not be necessarily more risky than standard financial instruments, they typically have terms, features and pose investment risks that may make it difficult for many customers, even non-retail customers, to appreciate fully.

IOSCO is therefore issuing the principles set forth below in order to promote robust customer protection in connection with the distribution of complex financial products by intermediaries, including guidance on how the applicable suitability requirements should be implemented<sup>16</sup>. To better achieve this goal, explanatory notes accompany the principles, which provide additional, detailed guidance on how the principles may be implemented.

The Principles include recommendations relating to both retail and non-retail customers, unless otherwise indicated. The precise application of these principles and explanatory notes will be a matter for policy makers at a national level reflecting their assessments of different groups of customers in their jurisdiction.

---

<sup>14</sup> See <http://www.iosco.org/library/resolutions/pdf/IOSCORES4.pdf>.

<sup>15</sup> See <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf>

<sup>16</sup> As mentioned above, in most of the surveyed jurisdictions, suitability requirements apply to all investment products. However, consistent with the project specification for this project, the following recommendations are only focused on the distribution of complex financial products.

This Report does not seek to provide a definitive or complete list of complex financial products, but sets forth in the glossary a set of criteria that help to identify such products. Nonetheless, IOSCO recognizes that the principles may be capable of being applied to financial products more broadly, subject to local circumstances.

In order to enhance customer protection and ensure a level playing field among different distribution models, these principles also apply, as appropriate, to the sales by intermediaries of complex financial products that they produce. Although the principles of this report apply only to intermediaries, we recognize the important relationship between product origination and structuring by non-intermediary product issuers, and the selection and distribution of such products by intermediaries. Indeed, in some jurisdictions, issuers may play a role in helping to ensure that material information about any complex financial product that they have issued is made available and/or clearly disclosed to the intermediary distributors or to the investors, including information about the risks that such products entail. Acknowledging the role of such issuers does not detract, however, from the regulatory responsibilities of the intermediaries who distribute such products to their customers.

IOSCO takes note of the June 2012 report drafted by its Task Force on OTC Derivatives on the regulation of Derivatives Markets Intermediaries<sup>17</sup>. That report sets forth recommendations with respect to transactions in OTC derivatives between non-retail parties<sup>18</sup>.

## **5. IOSCO Principles on Suitability Requirements with respect to the Distribution of Complex Financial Products**

### *➤ Classification of customers*

***Principle 1: Intermediaries should be required to adopt and apply appropriate policies and procedures to distinguish between retail and non-retail customers when distributing complex financial products. The classification of customers should be based on a reasonable assessment of the customer concerned, taking into account the complexity and riskiness of different products. The regulator should consider providing guidance to intermediaries in relation to customer classification.***

### **Means of implementation**

1. The regulatory system should establish a process to distinguish between retail and non-retail customers, in light of the complexity and riskiness of the different products that an intermediary should take into consideration when assessing suitability.

---

<sup>17</sup> See Final Report entitled: *International Standards for Derivative Market Intermediary Regulation* (June 2012), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD381.pdf>.

<sup>18</sup> The recommendations apply to the following substantive areas: (1) registration/licensing standards; (2) capital standards or other financial resources requirements for non-prudentially regulated DMIs; (3) business conduct standards; (4) business supervision standards; and (5) recordkeeping standards. It should also be noted that some jurisdictions do not apply certain conduct of business (including suitability) requirements to certain intermediaries/counterparties entering into a swap transaction with each other, due to the presumed sophistication of the parties. In these jurisdictions, one or more of this Report's principles may not be applicable to such transactions.

Possible criteria for the qualification of a customer as a retail or non-retail customer include objective indicators based on:

- The nature of the customer (e.g., regulated vs. unregulated entity; person acting in a business capacity vs. consumer);
  - Financial position;
  - Expertise, experience and knowledge with respect to complex financial products (e.g., frequency and size of previous investments, relevant professional experience in the financial sector, and with complex financial products in particular; relevant experience with trading the asset class or complex financial product in question); and
  - Ability of customers to assess independently or with the assistance of an independent adviser the value and features (including risks) of relevant products/transactions.
2. In some jurisdictions, certain suitability requirements are differentiated or waived (in whole or in part) depending on the customer classification. Nonetheless, caution should be exercised so as not to develop an overly broad presumption or definition of non-retail customer that could inappropriately limit the reach of suitability protections. Experience shows that presumptions may be inaccurate since they do not take into account the differences between entities, products and services. For example, during the recent financial crisis in some jurisdictions, some non-retail customers such as local authorities and municipalities appeared not to have understood the risks to which they were exposed, especially in the case of complex financial products. Accordingly, jurisdictions should consider whether additional protections are needed, particularly when public entities are involved.
  3. Intermediaries should not automatically rely on a customer's request for non-retail customer status or, where relevant, on the triggering of a given threshold or size. In this event, intermediaries should be required to make their own assessments on the level of expertise and knowledge of the customer, giving reasonable assurance, in light of the nature of the transactions or services provided, that the customer is capable of exercising his or her own independent judgment on the investment decisions and understands the risks involved. Where any ambiguity exists, intermediaries should consider the customer "retail."
  4. To the extent that the classification of customers is not determined by statute or regulation, the customer should be informed by the intermediary at the outset about what classification the intermediary has made and about the implications of such classification on the duties of the intermediary toward such customer.
  5. Some jurisdictions may allow customers who qualify as non-retail customers to elect to be treated as a retail customer. Moreover, intermediaries may be allowed to qualify and treat all customers as retail customers and afford them the corresponding higher level of protection<sup>19</sup>.
  6. Where the intermediary has an ongoing relationship with a customer (i.e., the customer continues to have an open account), the intermediary should be required to take reasonable steps to obtain updated or additional information from their customers on a periodic basis and

---

<sup>19</sup> Where permitted, some intermediaries may make the reasonable choice of treating all customers as retail because doing so may be more cost-effective than establishing separate categories for customers (e.g. "professional").

whenever the intermediary becomes aware that the information it has about a particular customer may be inaccurate. Should the intermediary become aware that a customer no longer fulfills the criteria that made him eligible for classification as a non-retail customer, the intermediary should be required to take appropriate action with respect to any subsequent transactions.

➤ *General duties irrespective of customer classification*

***Principle 2: Irrespective of the classification of a customer as retail or non-retail, intermediaries should be required to act honestly, fairly and professionally and take reasonable steps to manage or mitigate conflicts of interest through implementing appropriate procedures in the distribution of complex financial products, and where there exists a potential risk of damage to the customer's interest, the intermediaries should, where appropriate, be required to clearly disclose the risk.***

### **Means of implementation**

1. The overarching high-level principle to act honestly, fairly and professionally and the general duty of good conduct should apply irrespective of the customer classification, including in those jurisdictions where intermediaries are authorized to provide services to customers whose level of expertise may permit a “waiver”, in whole or in part, of the protections offered by suitability rules.
2. This principle implies, for instance, that intermediaries should gather essential facts concerning every customer at the point of starting the business relationship and shall be responsible to deal fairly, protect the customer's assets they hold and not mislead him or her in their business dealings. Irrespective of any customer classification, intermediaries should be required to take reasonable steps to manage or mitigate conflicts of interests through implementing appropriate procedures and measures and where there exists a potential risk of damage to the client's interest, the intermediary should be required to clearly disclose, where appropriate, the nature and/or source of conflict to the customer concerned before the provision of the service or the performance of the relevant transaction, so as to allow the customer to make an informed decision.
3. Subject to local regulatory requirements, when conflicts of interest are inherent to the transaction, such as a principal-to-principal relationship<sup>20</sup>, the conflicts could be managed or mitigated through implementing appropriate procedures and measures and, where there exists a potential risk of damage to the client's interest, through further disclosures, such as identifying how the intermediary's interests may be adverse to its customer's interest. Intermediaries should also have policies and procedures to assess whether the customer has sufficient knowledge and expertise to evaluate the transaction and to evaluate any conflicts of interest that are inherent to the transaction.

---

<sup>20</sup>

While most securities regulators do not define a principal-to-principal transaction *per se*, such a transaction might be described as one where the trader executes the trade for its own account rather than the account of a client. Such a principal-to-principal transaction can be distinguished from a traditional intermediary relationship, i.e., where a broker acts as agent on behalf of another party (and earns a fee for doing so) and where such agent does not share in the economic risk of the transaction or participate in any benefit arising from the transaction.

➤ *Disclosure requirements*<sup>21</sup>

***Principle 3: Customers should receive or have access to material information to evaluate the features, costs and risks of the complex financial product. Any information communicated by intermediaries to their customers regarding a complex financial product should be communicated in a fair, comprehensible and balanced manner.***

## **Means of implementation**

1. Whenever intermediaries disclose or make available to their customers information regarding a complex financial product, whether as a matter of firm policy or regulatory mandate, reasonable care should be given to assist customers in making an informed investment decision, particularly in making them aware, before the purchase, of the specific (net of cost) risk-return profile of the complex financial product. Any information disclosed and prepared by the intermediary to the customer regarding a complex financial product should present a fair, clear, comprehensible and balanced picture regarding both the risks and potential benefits they pose, especially when the product's performance is sensitive to extreme scenarios. In particular, where an intermediary provides the customer with scenario analysis, it should be based on reasonable assumptions and presented in a way that does not overstate the potential benefits and understate the risks of the complex financial product. This is because complex financial products may have features and pose investment risks that are difficult for many customers, even non-retail customers, to appreciate fully. In some instances, these products link high return rates to certain favorable, but unlikely scenarios, which may be used to create or enhance customer interest.
2. Intermediaries should not intentionally give their customers the false impression that complex financial products are comparable to non-complex plain-vanilla securities; rather customers should receive or have access to a description of the different components of the product and how these components interact and affect the risks.
3. Disclosure requirements should apply to the intermediary whenever it advises or otherwise recommends the purchase of a complex financial product. For example, the regulatory system should require that intermediaries recommending a complex financial product provide information to the retail customer on the features, specific risks, fair value, and other material aspects of the complex financial product. Such disclosure requirements should be tailored, as appropriate, to the type of customer.

Based on the classification of customers in some jurisdictions, there may be customers who do not fall within the scope of a retail customer, but may not have the level of skill or knowledge in order to be able to gather and assess the information needed on the purchase of a complex financial product. This could be the case where a customer meets certain income thresholds, but yet does not have the level of sophistication of an institutional investor. As noted below under Principle 5, where the intermediary recommends to a customer to purchase a complex financial

---

<sup>21</sup> Although the focus of this, as well as other principles, is on intermediaries, nothing in this section is meant to prevent regulators from imposing obligations on product providers and manufacturers with regard to disclosure, including, e.g., requiring product providers to provide offering materials for registered securities detailing product information.

product, the intermediary should consider the customer's investment experience, objectives and knowledge in relation to the complex financial products.

4. Customers should have reasonable access to information that allows them to identify costs and charges relating to the purchase of a complex financial product including, ideally, if practical and feasible, on an unbundled basis (i.e. a breakdown of the components of the total price).

When a liquid secondary market for a complex financial product does not exist, the only prices available may be from the intermediary that sold the customer the product. The intermediary should know and disclose ahead of time how these prices will be computed (using models, other markets for similar products, etc.) and what the price represents (mid-market theoretical value, re-purchase prices, etc.). The customer should have access to enough information to know that the product is illiquid, including information about the means and range of timing for disinvestment.<sup>22</sup>

5. Where practical and feasible, intermediaries should seek to provide customers with comparative information concerning appropriate alternative investment products, to the extent that such products are available.
6. Regulators should consider requiring a particular form of disclosure where products carry risks that may not be readily apparent to customers, particularly retail customers. In particular, regulators may require the employment of a simplified and user-friendly format summarizing the key features of the complex financial product.

➤ *Protection of customers for non-advisory services*

***Principle 4: When an intermediary sells a complex financial product on an unsolicited basis (no management, advice or recommendation), the regulatory system should provide for adequate means to protect customers from associated risks.***

### **Means of implementation**

1. All regulatory systems should provide for, as appropriate, adequate minimum protections even where a customer purchases a complex financial product on an unsolicited basis.
2. Possible protections include:
  - a. Assessing the level of knowledge and experience of the customer in the investment field relevant to the specific type of product or service (e.g., effectively prohibiting execution-only services in connection with the distribution of certain complex financial products);
  - b. Warning the customer that the transaction may not be appropriate or that it would be prudent to take investment advice;

---

<sup>22</sup> For instance, the customer should be informed if the intermediary or another entity belonging to the same group is the only source of liquidity for the instrument.



- c. Disclosing to the customer the features and specific risks associated with the transaction;
- d. Imposing specific requirements with respect to transactions in certain complex financial products (e.g., index warrants, currency index warrants and options), including requiring written approval by firm managers to authorize the opening of an account to trade such products;
- e. Requiring the intermediary to assess whether it is advisable to offer a particular customer a service whereby they would gain access to a platform where they could trade complex financial products (e.g., retail trading platforms on contracts for difference, margin trading); and
- f. Prohibiting or restricting the distribution of certain categories of more risky or complex financial products to certain categories of customers, such as retail customers.

➤ *Suitability protections for advisory services (including portfolio management)*

***Principle 5: Whenever an intermediary recommends the purchase of a particular complex financial product, including where the intermediary advises or otherwise exercises investment management discretion, the intermediary should be required to take reasonable steps to ensure that recommendations, advice or decisions to trade on behalf of such customer are based upon a reasonable assessment that the structure and risk-reward profile of the financial product is consistent with such customer's experience, knowledge, investment objectives, risk appetite and capacity for loss.***

## **Means of implementation**

1. In light of the greater reliance of customers on the recommendations and advice provided, or on the exercise of investment discretion by the intermediary, the provision of such advisory or discretionary services calls for stricter protections.
2. The regulatory system should require intermediaries to comply with suitability requirements, calibrated to the complexity and riskiness of the product and service and the level of sophistication of the customer. For example, suitability requirements may differ depending on whether the service being offered to the customer is advisory or discretionary investment management. If an intermediary's behavior amounts to making a recommendation to a customer, it cannot avoid its suitability obligation by claiming that it has not made any recommendation to such customer.
3. Before recommending complex financial products to customers, intermediaries should gather and retain information from such customers relevant to the specific type of product or investment service.
4. Intermediaries should have a robust process to assess the profile of a customer for whom a suitability determination would apply on the basis of, among other things, the following factors relating to the customer:

- Investment objectives, including the length of time for which they wish to hold the investment. Age of the customer may be relevant for this factor;
  - Risk tolerance and relevant risk preferences, taking into account the purpose of the investment and the need for portfolio diversification;
  - Financial situation (e.g., the customer's other assets, income and tax liabilities) and general capacity to withstand losses of trading complex financial products;
  - Investment experience and knowledge in relation to complex financial products, including the nature, volume and frequency of previous transactions and level of familiarity with relevant complex financial products and services. The customer's profession, former professional experience, and level of financial education may also be relevant;
  - Liquidity needs;
  - Any other relevant information the customer may disclose to the intermediary in connection with the recommendation.
5. Before recommending complex financial products to customers, intermediaries should themselves develop a thorough understanding of the features of the relevant product and its complexity and associated risks<sup>23</sup> taking into account, when providing individual portfolio management or advice, the composition of the customer's portfolio.
6. In particular, in the case of complex financial products, the intermediaries should perform their own analysis that considers:
- how the complex financial products are structured and priced;
  - the nature and complexity of a product's pay-off and underlying components, if any;
  - the relevant level of risk (with, if appropriate, a separate assessment of counterparty, liquidity and market risks);
  - the experience and reputation of the issuers and product providers/manufacturers;
  - any fees, charges or any other costs associated with the product;
  - the level of liquidity;
  - the lock-in periods and relevant termination conditions exit options and associated costs;
  - how the product performs under abnormal or extreme conditions; and
  - the nature of any guarantees<sup>24</sup>.

Care should be given to the different components of a complex financial product in order to foster customer understanding of the risks associated with them. The complex financial products

---

<sup>23</sup> In some jurisdictions, this is referred to as "reasonable basis" suitability (meaning that the intermediary must determine that the product is at least suitable for someone).

<sup>24</sup> For illustrative purposes, an example of possible issues an intermediary should address when carrying out complex financial products' due diligence is provided for under Annex 2.

selected by intermediaries for distribution to their customers should in general meet the needs of the customer group at which the intermediary aims its services.

7. In making the recommendation, the intermediary should consider whether among the products it offers there are less complex, less costly alternative financial products that would be more suitable for the customer.
8. Any suitability obligations should apply both to the intermediary itself and to its representatives with regard to both required due diligence and any recommendation made to a customer. The intermediaries' sale staff should be trained to understand the features and risks associated with each complex financial product they recommend to meet suitability obligations.
9. In addition, when a liquid secondary market for the product does not exist, intermediaries should draw the attention of the customer to this fact and, where applicable, assess the fair value through methodologies, modeling and standards generally recognized and accepted in the market and consistent with those used by the intermediaries to value their own proprietary portfolios. Where a liquid secondary market does not exist, this might be communicated by, for example, explaining the costs and other consequences of terminating the product holding before its full term.
10. After assessing the characteristics of the customer and the product, intermediaries should determine whether the features and risks of the product are in fact suitable to the profile of that particular customer, including, but not limited to, whether the duration and liquidity of the proposed investment match the needs of the customer, taking into consideration his/her investment time horizon. In the case of a customer seeking products specifically for hedging purposes, intermediaries should check for consistency between the hedging needs of the customer and any products recommended.
11. Intermediaries should keep written evidence of the information required by the regulator to be gathered from customers as part of the suitability determination. In addition, regulators should require intermediaries to retain documentation to the extent that such written documentation is created, to evidence any inquiries and analysis they made when carrying out the product and customer due diligence.
12. Regulators should consider providing guidance to facilitate the discharge of the suitability responsibilities in the distribution of complex financial products as new and complex financial product continue to emerge.

***Principle 6: An intermediary should have sufficient information in order to have a reasonable basis for any recommendation, advice or exercise of investment discretion made to a customer in connection with the distribution of a complex financial product.***

### **Means of implementation**

1. Before an intermediary recommends the purchase of a particular complex financial product, or purchases the product for its customer as part of its provision of discretionary management services for the customer, the regulatory system should require the intermediary to obtain the information necessary to make a reasonably based recommendation concerning the suitability of the complex financial product to that particular customer.
2. Examples of possible approaches to implement this principle include, at a minimum, that where a customer fails to provide all information requested by the intermediary, the intermediary should be required to consider whether it has sufficient information to make a reasonably based recommendation. Where the intermediary determines that it does not have sufficient information, then it should be:
  - a) Prohibited from making the recommendation or providing the service to the customer; or alternatively
  - b) Where permitted to recommend the investment, it should be required to make clear that the recommendation is based upon limited information.
3. In either case, the intermediary should be required to act consistent with the best interests of the customer.<sup>25</sup>
4. Intermediaries should not recommend complex financial products they do not understand.
5. Another possible means to mitigate the risk of mis-selling would be to grant regulators, where there are substantial investor protection issues raised, the power to prohibit or restrict automatically the recommendation of certain categories of more risky or complex financial products to certain categories of customers, such as retail customers.

---

<sup>25</sup> See footnote 12.

➤ *Compliance function and internal suitability policies and procedures*

***Principle 7: Intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability requirements, including when developing or selecting new complex financial products for customers.***

**Means of implementation**

1. Intermediaries should be required to develop and maintain internal processes and procedures with a view to ensuring compliance with the suitability requirements, the management of conflicts of interests, the proper conduct of business and the fair treatment of all customers, including in the distribution of complex financial products. Effective internal reporting and communication of information at all relevant levels of the intermediary should be established<sup>[2]</sup>.
2. More specifically, intermediaries should put in place and enforce written strategies, processes and controls in view to ensure that any financial products they intend to distribute, especially complex financial products, are suitable for the type of customers they intend to solicit.
3. When developing or selecting complex financial products for distribution, intermediaries should establish appropriate ongoing internal processes for identifying, periodically reviewing and approving (or rejecting) the products in order to promote their compatibility with the characteristics and needs of the prospective customers they intend to target. This includes policies and procedures that support the design of products appropriate for particular customers. For instance, products should not be designed so as to hamper intentionally the ability of targeted customers to understand the risk-reward profile.
4. The compliance function should verify that the above internal processes and procedures are properly functioning.

---

<sup>[2]</sup> See *Compliance Function at Market Intermediaries – A report of Technical Committee of the IOSCO*, of March 2006 where IOSCO advocated the establishment by intermediaries of a compliance function proportionate to the scale and type of their business and stated that the compliance function should be able to operate on its own initiative, without improper influence from other parts of the business, and should have access to senior management and/or, as appropriate, to the regulator. Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD214.pdf>

➤ *Incentives*

***Principle 8: Intermediaries should be required to develop and apply appropriate incentive policies designed to ensure that only suitable complex financial products are recommended to customers***

**Means of implementation**

1. Intermediary and staff compensation policies should be designed to ensure that only suitable complex financial products are recommended to the customer. Of particular concern is that the distribution of complex financial products by an intermediary can be more lucrative than selling “plain vanilla” securities, thereby creating selling pressures and incentives to encourage unsuitable transactions. Moreover, charges associated with the purchase of complex financial products may often be less apparent to the customers and harder to understand.
2. Senior management should be responsible for regularly reviewing incentive schemes and distribution practices by sales staff.
3. Intermediaries’ remuneration structures and related sales staff incentive programs should not conflict with the duty to act honestly, fairly and professionally, and consistent with the best interests of the customer<sup>26</sup>. In particular, the intermediary should avoid any incentives to its sales staff to recommend a certain complex financial product when the intermediary could offer a different financial product that would better meet the customer’s needs.
4. Regulators should consider taking steps to require disclosure of remuneration structures and policies (e.g., commissions received by the distributors from the product issuers) as a means to reduce the risks of financial incentives that could lead to unsuitable advice or recommendations.

➤ *Enforcement*

***Principle 9: Regulators should supervise and examine intermediaries on a regular and ongoing basis to help ensure firm compliance with suitability and other customer protection requirements relating to the distribution of complex financial products. The competent authority should take enforcement actions, as appropriate. Regulators should consider the value of making enforcement actions public in order to protect customers and enhance market integrity.***

**Means of implementation**

1. The regulatory system should provide strong and effective incentives for intermediaries to comply properly with their suitability requirements and other protection requirements, especially when they sell complex financial products to retail customers.
2. Regulators should take appropriate steps to help ensure that intermediaries duly comply with these obligations. To this end, on-site and off-site visits, as well as thematic reviews should be

---

<sup>26</sup> See footnote 12.

conducted to monitor that intermediaries have put in place the necessary internal processes and procedures to ensure compliance with the suitability requirements and other protection requirements. To make the most effective use of resources, intermediaries may be selected for review using a risk-based methodology.

3. Particularly where intermediaries belong to a multinational group, relevant regulators should make efforts to cooperate, as appropriate, with regard to their supervisory actions.
4. In the course of their supervisory and enforcement activity, regulators should also take into consideration the manner in which intermediaries address customer complaints and resolve any disputes with their customers.<sup>[3]</sup>

---

<sup>[3]</sup> This report does not address the liability of intermediaries to their customers in cases where violations of suitability obligations or other customer protection requirements cause damages. The conditions for such civil liability may vary depending on the applicable jurisdiction. However, a regulatory system that recognizes the civil liability of intermediaries to customers may provide a meaningful incentive for intermediaries to discharge properly their suitability obligations.

## **Annex 1**

### **FEEDBACK STATEMENT ON THE PUBLIC COMMENTS RECEIVED ON THE CONSULTATION REPORT ON “*SUITABILITY REQUIREMENTS WITH RESPECT TO THE DISTRIBUTION OF COMPLEX FINANCIAL PRODUCTS*”**

#### **Background**

This Feedback Statement provides a summary of the main feedback received by IOSCO to its Consultation Report on “*Suitability Requirements with respect to the Distribution of Complex Financial Products*” which the Technical Committee of IOSCO published in February 2012, together with our proposed way forward in response to that feedback.

The deadline for comments was May 21, 2012. IOSCO received 19 responses: 2 from Regulators, 1 from a Self-regulatory Organization, 1 from a Private Natural Person and the others from Industry Representatives (see Enclosure 1 hereto). IOSCO is grateful to all those who provided responses.

This feedback statement does not exhaust all contributions IOSCO received, but it is meant to provide an indication of the major trends.

The vast majority of the comments received were of a technical nature and were mostly intended to suggest ways to clarify the principles or to make them more specific consistent with the spirit of the principles. We have tried to incorporate these comments as much as possible into the final version of the Report, except where they appear to be too country-specific or prescriptive (given the variety of business models intermediaries may choose to operate in the distribution of complex financial products), or already sufficiently covered by the existing principles.

#### **GENERAL COMMENTS**

All respondents broadly supported the principles, since they address a major issue emerged from the financial crisis, i.e. the appropriate protection of investors of all levels of sophistication and capability in relation to the sale of products with complex structure. Moreover, the principles are intended to promote uniform standards on suitability as far as possible, in a way that would reduce regulatory and product arbitrage, mitigating any potential damage to investor protection from different or divergent national or regional approaches to this issue.

#### **1. Scope of the Principles**

As regards scope, many respondents commented that, in their opinion, the principles should not be limited to complex financial products but rather capture all financial products, regardless to their complexity, on the basis that any rule aiming to protect investors should also take into account the element of risk inherent to an investment in a specific financial product. Moreover, some respondents suggested focusing on the “riskiness” of the products, rather than on “complexity”, since the element of risk does not necessarily depend on whether the structure of the product is complex or not.

C3 recognizes that many of the principles are capable of broader application and, in general that the relevance of suitability rules goes beyond complex financial products. However, in light of the financial crisis and the mandate from the IOSCO Technical Committee, we believe that the report should remain focused on complex financial products because of the specific issues they present.



In particular, although greater product complexity does not necessarily equate to greater product risks, the level of complexity and opaqueness of a financial product's structure will affect the ease with which the risk / reward profile attached to the product may be understood by potential investors.

Notwithstanding, in order to acknowledge the point raised by respondents, C3 has inserted new text in the preliminary section aimed at explaining the focus on complex financial products. Further, in the section titled "Purpose of the Principles", it is recognized that the principles may be capable of being applied to financial products more broadly subject to local circumstances.

Finally, the definition of "Complex Financial Products" in the Glossary has been amended to further underline the fact that the key issue with complexity is the difficulty by investors to understand the downside risks.

## **2. Prohibition / restriction on recommending certain complex financial products to certain customers**

Some respondents expressed opposition to the approach of regulators restricting the recommendation of certain complex financial products to a particular category of customers, such as retail customers. In particular, respondents observed that a general ban would not permit an assessment of individual investor, who, even if included into the category of "retail client", could have broad financial knowledge, experience and resources. Respondents suggested the adoption of a disclosure approach instead.

In response to this feedback, C3 notes that the reference to the prohibition / restriction on such recommendations is worded in a non-prescriptive way, as one possible means of investor protection (see principle 6, par. 5). It should be recognized that, in many jurisdictions this is considered to be an important measure to protect certain investors, at least in certain circumstances. In order to acknowledge that this is expected to be a "last resort" measure, paragraph 5 of principle 6 has been amended slightly aimed at describing the circumstances where such powers are expected to be exercised.

## **3. Role of product issuers / manufacturers**

Several respondents commented that the Consultation Report did not take into account the whole distribution chain. According to these respondents, the principles should reflect the fact that the process involves not only investors and market intermediaries but also product issuers and manufacturers. Therefore, they suggest that IOSCO provides specific guidance in this respect.

C3 notes that the Report does take into account the role of product issuers as appropriate. In particular, as stated in the Report (see par. titled "Purpose of the recommendation"), the Principles also apply to the direct sales by market intermediaries of complex financial products that they produce. In addition, Principle 7 provides guidance on the designing of products by intermediaries.

Nonetheless, in order to acknowledge the role of ongoing product governance in developing and selecting complex financial products for distribution, the relevant paragraph under "Purpose of the Principles" and the explanatory note to Principle 7 have been amended in line with several respondents' suggestions.

It should also be noted that while the mandate of C3 is limited to intermediaries and distribution related issues, additional more specific guidance on product manufacturing will possibly be provided in the context of the IOSCO TFUMP project on structured products.

#### **4. Intermediaries providing ongoing services**

A number of respondents commented on the need to find an appropriate balance between the responsibilities of customers, e.g., in terms of providing updated information to intermediaries on changes relevant to their status as customers, and the obligations of intermediaries, especially where an ongoing service is provided.

In response, C3 has inserted appropriate amendments in the explanatory text of Principle 1 (paragraph 6).

#### **SPECIFIC COMMENTS**

##### *Chapter 2 - Glossary*

A few comments were received relating to the definitions provided in the Glossary of the Consultation Report, mostly linked to the general comments outlined above.

With regard to the definition of “complex financial products”, some respondents remarked that complexity does not necessarily involve additional risk and that consequently the definition should be linked to the riskiness of the product. Other respondents supported the proposed definition (which does not provide for a definitive list of financial products but establishes criteria and gives examples) on the basis that, in view of financial innovation and geographic differences, such an approach is more appropriate and will avoid the creation of regulatory loopholes.

Further a few respondents stressed that the definition of intermediary should be extended to include also product manufacturers, which point is also addressed above.

##### *Principle 1 – Classification of customers*

Virtually all the respondents recognized that the Consultation Report provided for a reasonable distinction between retail and non-retail customers.

Several respondents suggested making the principle more straightforward in the light of the explanatory text, focusing on customer’s capability to understand the risk involved rather than on the complexity and riskiness of the product.

C3 believes that the text of the Principle is already focused on the customer, being the complexity and riskiness of the product simply an additional element that intermediaries are expected to take into account in the customer classification. Moreover, appropriate amendments have been inserted in the explanatory text of Principle 1 (paragraph 1) to clarify the elements to be taken into account in the assessment of the customer, which should include expertise, experience and knowledge with complex financial products.

Most respondents agree that intermediaries should not automatically rely on customer demand for non-retail customer status, but that they should carry out their own assessment.

Moreover, a couple of comments suggested adding further granularity to the customer's classification by distinguishing between different types of non-retail investors.

In this respect, C3 notes that nothing in Principle 1 prevents intermediaries from further segmenting their customers should they wish to. The purpose of the principle is rather to provide more specific guidance on the regulatory distinction between retail and non-retail classification and relevant consequences.

#### *Principle 2 - General duties irrespective of customer classification*

Almost all respondents welcomed the introduction of a general obligation of fair treatment irrespective of customer classification.

In this regard, some respondents suggested providing more guidance in the explanatory note on how intermediaries are expected to comply with the Principle, whilst others propose to strengthen the principle further by the adoption of a the duty to act consistent with the best interest of the customer.

In response, C3 has introduced additional text to paragraph 2 where examples of good practices by intermediaries are provided for and specified the standard on the management of conflicts of interest.

#### *Principle 3: Disclosure requirements*

All respondents broadly supported this principle.

Several respondents suggested that the principle should introduce a responsibility for product issuers and manufacturers in giving distributors information on complex financial products through appropriate fact-sheets or term-sheets.

C3 underlines again that these principles are focused on intermediaries as defined in the IOSCO Principles, without covering non-intermediaries product issuers or manufacturers. Therefore, without prejudice to any further additional guidance on product issuers that IOSCO may wish to provide, Principle 3 should stay focused on the information flows from the intermediary/distributor to the customer.

Moreover, a large number of commenters support a reasonable selection of the information to be disclosed possibly through a key information document (as provided in the EU legal framework), in the belief that this requirement could ensure understandable information and ease the comparison between different products.

C3 considers key investor document to be a useful tool intermediaries may wish to employ when disclosing information to their customers and clarified this further under par. 8 of the explanatory note.

Furthermore, a number of respondents commented that the provision of “comparative information” to the customer where practical and feasible should be qualified in order to ensure that this does not conflict with the business models chosen by a firm.

C3 has included new language in the relevant paragraph of the explanatory note to this purpose.

A few respondents asked for clarification about the information to be provided on an unbundled basis on cost and charges relating to the purchase of a complex financial product. C3 has introduced some changes into paragraph 5 in this respect.

#### *Principle 4: Protection of customers for non-advisory services*

Several respondents were not in favor of the possibility of a prohibition or restriction on distributing certain complex financial products to certain categories of customers, such as retail customers.

Some respondents also supported the view that the freedom for the customer to buy a complex financial product even if deemed unsuitable by the intermediary should remain.

In this respect C3 wishes to note that the principle does not provide for any general ban to distribute complex financial products to retail customers, but rather includes this as one of a number of possible protections for customers of complex financial products.

A number of stakeholders commented that the principle is ambiguous and would not promote a sufficiently common international approach.

C3 acknowledges that the principle is intentionally worded in a flexible manner in order that each jurisdiction should provide for regulatory means for appropriate customer's protection even where no recommendation or advice is given.

#### *Principle 5 and 6: Suitability protections for advisory services*

All respondents broadly support these principles.

Several respondents commented that the explanatory text of Principle 5 should be more specific in relation to the staff to be covered, since the current wording could be read as implying that all the suitability regulation should apply to all employees irrespective of their roles. Other respondents expressed the opportunity to emphasize the importance of training individuals. C3 agrees with the above suggestions and have inserted appropriate wording in paragraph 8 of the explanatory text to Principle 5.

It was also suggested to strengthen the guidance relating to the internal processes and procedures, including recordkeeping requirements, that intermediaries should apply in carrying out due diligence on complex financial products, as well as to require regulators to issue periodic guidance on suitability requirements as new and complex products continue to emerge. C3 acknowledges the importance of these points and has inserted amendments in paragraphs 11 and 12 of the explanatory text to Principle 5.

As regards Principle 6, some comments propose to clarify that the principle applies to the collection of information both on customers and complex financial products, since the current wording seems to focus more on information about the customer. C3 agrees with the suggestion and has inserted appropriate revisions to this end.

Many respondents were against any prohibition or automatic restriction on recommending certain categories of complex financial products to certain categories of customers and requested qualification of the text to avoid an overly expansive interpretation of this provision. As mentioned above C3 has introduced additional qualifications in paragraph 5 of Principle 6.

Moreover, a number of respondents also recommended the amendment of the text relating to reducing inducements to purchase a financial product where the customer neither understands the product, nor is capable of assuming the financial risks, since it might lead to misunderstandings regarding the term "inducements" or "incentives". C3 agrees and amended wording of paragraph 1 of Principle 6 has been adopted.

### *Principle 7: Compliance function and internal suitability policies and procedures*

All the respondents expressed strong support for the establishment of a compliance function and the development of internal policies and procedures to ensure the enforcement of suitability obligations.

In this regard, most respondents provided IOSCO with some additional guidance on duties and powers that the compliance function might have and suggested changes such as, for instance, the adoption of a proportionality principle. C3 observes that, as reflected in footnote no. 2 of the explanatory note to Principle 7, IOSCO already recognizes that the compliance function should be proportionate to the scale and the type of the intermediary's business.

Several respondents highlighted the importance of ongoing product governance. C3 acknowledges that the relevance of the issue and has introduced new text in the explanatory note in this respect.

### *Principle 8 - Incentives*

Respondents broadly supported this principle.

Most comments suggested rewording into a more positive statement, in order to avoid the false impression that incentives to recommend unsuitable products are permitted.

Some respondents stressed that the successful application of the principle might not be achieved if the intermediary's compensation structures remain geared towards sale targets.

C3 has amended the language of the principle and explanatory note in view to take into account of these comments.

### *Principle 9 - Enforcement*

All respondents expressed support for this principle.

Some comments suggested additional measures that regulators could undertake to ensure the correct enforcement of suitability requirements.

C3 has taken most of these suggestions on board

## **ENCLOSURE I**

### **List of respondents**

#### **Regulators**

- Dubai Financial Services Authority (DFSA), United Arab Emirates;
- Hungarian Financial Supervisory Authority's (HFSA), Hungary.

#### **Self-Regulatory Organizations**

- Financial Industry Regulatory Authority (FINRA), USA.

#### **Industry representatives**

- Association of the Luxembourg Fund Industry - Association Luxembourgeoise des Fonds d'Investissement (ALFI), Luxembourg ;
- Bundesverband Investment and Asset Management (BVI), Germany;
- CFA Institute, UK;
- Deutsche Bank AG, Germany;
- Deutscher Derivate Verband (DDV) – German Derivatives Association, Germany;
- Financial Planning Standards Board (FPSB), USA;
- Financial Planning Standards Board India (FPSB India), India;
- German Banking Industry Committee (GBIC), Germany;
- Institute of International Finance, the International Banking Federation, and the Joint Associations Committee on Retail Structured Products (the JAC), together 'the Associations';
- Insurance Studies Institute (ISI), USA;
- International Council of Securities Associations (ICSA), USA;
- Investment Management Association, UK;
- St. James's Place Wealth Management, UK;
- UniCredit Bank, Italy;
- World Federation of Insurance Intermediaries, Brussels.

#### **Private Natural Persons**

- Chris Barnard, Germany.

## **Annex 2**

### **Issues which may be considered by intermediaries when carrying out product due diligence in assessing suitability of a complex financial product**

- For whom is the product intended, e.g., limited or general retail distribution? If limited, how will the firm prevent distribution beyond the targeted customer group?
- What is the product's investment objective and how does the product improve upon the firm's current offerings? Are less complex, less costly, and/or less risky products available to accomplish the same investment objective(s)? Are the product's costs transparent to investors to allow independent cost comparison with other products?
- What key assumptions underlie the product's performance over time, e.g., market behavior, interest rate changes, market volatility and market liquidity? What are the qualifications of the persons making the assumptions that underlie projections of the product's performance?
- How a complex financial product is structured and priced, its underlying components, its functions, and how it is described to the customer. In other words, does the complexity of the product impair understanding and transparency of the product? If so, what are the implications for the training requirements for the sales staff? Will the product require development or refinement of in-house training programs for sales personnel and their supervisors? In what respects?
- What promotional or sales materials will be used to market the product? What risks must be disclosed and how will those disclosures be made? What sorts of disclosures are needed to achieve a balanced promotion of the product to the targeted customer group?
- The relevant level of risk (with, if appropriate, a separate assessment of counterparty, liquidity and market risks). For example, what are the product's principal risk factors? Do they include any currency, legal, tax, market, or credit risks?
- The experience and reputation of the issuers;
- Any fees, charges or any other costs associated with the product;
- How liquid is the product? Will there be an active secondary market for the product, e.g., with liquidity providers? How will the fact that a particular product is illiquid impact its valuation during its life span? Will the product be marginable?
- The lock-in periods, exit options and associated costs; and
- The nature of any guarantees.