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Structured Thoughts

News for the financial services community.

IOSCO Publishes Suitability Requirements for Distribution of Complex Financial Products

On January 21, 2013, the International Organization of Securities Commissions (IOSCO), of which the Financial Industry Regulatory Authority, Inc. is an affiliate member, published its final report on Suitability Requirements With Respect to the Distribution of Complex Financial Products. The report can be found at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf.

The report sets forth nine principles relating to the distribution of complex products by "intermediaries" (defined below), and, for each of the principles, "means of implementation," which include suggested regulatory changes and detailed guidance for intermediaries. The purpose of the principles is to "promote robust customer protection in connection with the distribution of complex financial products by intermediaries," including providing guidance on how the applicable suitability requirements should be implemented. The principles are intended to address concerns raised by regulatory authorities and others about sales of structured products, particularly to retail investors. The focus is on not only the point of sale but also on the intermediary's internal procedures related to suitability determinations.

Many of the themes raised in the report have also been discussed by U.S. regulatory authorities in the past year, including suitability and sales practices. The report suggests that regulators should have the power to impose outright bans on sales of some complex financial products in certain situations. Of course, each jurisdiction has a different legal and regulatory regime and, as a result, the report contains certain general statements that would not be uniformly applicable.

Reaction from the Securities and Exchange Commission, an IOSCO member, was swift and negative. On January 22, 2013, Commissioners Troy A. Paredes and Daniel M. Gallagher issued a statement that the SEC objected to, and did not approve, the publication of the report, and that the report does not accurately reflect U.S. law. The Commissioners also

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stated that the U.S. regulatory regime should not conform to the report's recommendations, with which the Commissioners disagreed in key respects. In particular, they noted that the report failed to "properly respect the distinction between retail and institutional investors when determining the suitability requirements that should apply." The statement is available at http://www.sec.gov/news/speech/2013/spch012213dmgtap.htm.

Glossary

The report includes a glossary of relevant terms, which are quoted and summarized below.

"**'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). The term generally includes, but is not necessarily limited to, structured instruments, credit linked notes, hybrid instruments, equity-linked instruments and instruments whose potential pay-off is linked to market parameters, asset-backed securities …, mortgage-backed securities …, collateralized debt securities, and other financial derivative instruments (including credit default swaps and covered warrants)…."

The report also noted that complex financial products may not necessarily be liquid, even if listed on an exchange. Also mentioned was that the valuation of complex financial products is accomplished through complex financial models, which may not be understood by retail investors.

"**'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) …."

"**'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'** 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). In jurisdictions where banks are permitted to provide investment services, this term includes banks to the extent they are providing such services."

The report noted that, for purposes of the report, "the term 'intermediary' in the U.S. securities sector refers to registered swap dealers and broker-dealers, not investment advisers." The definition also includes firms that are product providers who are also intermediaries, and that directly distribute complex financial products that they produce. Issuers who are not intermediaries are excluded from the definition.

"**'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. 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 ...."

The Existing "Suitability" Landscape

The report briefly surveyed the status of existing suitability requirements, summarizing suitability requirements as "generally aim[ing] 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."

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The report noted that although the phrase "in accordance with the best interests of the customer" may suggest the application of a fiduciary standard, in some common law jurisdictions, intermediaries may be subject to a duty to act fairly, honestly and in good faith while not being subject to a fiduciary standard of care.[1]

One concern was that existing suitability requirements may not protect against intermediaries being incentivized to sell products created by intermediaries or their affiliates, particularly during a "crisis period" in which firms face difficulties in raising capital from the public and other revenue sources may not be available.

The Nine Principles

The report presents nine principles, which fall into eight broad categories. The principles are quoted, and the related means of implementation are summarized, below.

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.

Suggested means of implementation include:

- 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.
- Suggested possible criteria for distinguishing retail versus non-retail customers include:
    - Nature of the customer (regulated versus non-regulated entities; person acting in a business capacity versus consumer)
    - Financial position;
    - Expertise, experience and knowledge with respect to complex financial products; 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.
- Intermediaries should avoid developing an overly broad presumption or definition of non-retail customers, for which suitability requirements may be differentiated or waived.
- Intermediaries should avoid automatically relying on a customer's request for non-retail customer status; intermediaries should make their own assessments on the customer's level of expertise and knowledge; when in doubt, the customer should be considered "retail."
- If customer classification is not determined by statute or regulation, the customer should be informed by the intermediary of its status, the implication of such classification and the duties of the intermediary toward that customer.
- Intermediaries may be allowed to treat all customers as retail, which offers the corresponding higher level of protection. The report notes that this may be more cost-effective than maintaining separate categories.

[1] This duty is reflected in the standards required of EU intermediaries under the EU's Markets in Financial Instruments Directive.

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- Intermediaries should be required to take reasonable steps to update information with respect to customers with which there are ongoing relationships on a periodic basis and whenever an intermediary becomes aware that a customer's information may be inaccurate. If an intermediary becomes aware that a customer is no longer "non-retail," 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.

Suggested means of implementation include:

- Intermediaries should not waive this principle, even in jurisdictions in which the customer's level of expertise may allow a waiver.

- Intermediaries should gather essential facts about customers at the start of the relationship.

- Intermediaries should take reasonable steps to manage or mitigate conflicts of interest through implementing appropriate procedures; if 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.

- When conflicts cannot be avoided, the conflicts could be managed or mitigated though implementing appropriate procedures and measures and, when 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.

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.

Suggested means of implementation include:

- Customers should be made aware, before the purchase, of the specific (net of cost) risk-return profile of the complex financial product.

- Scenario analyses should be based on reasonable assumptions; presentations should not be skewed toward overstating potential benefits and underplaying potential risks.

- Extra care should be taken if the product is sensitive to extreme scenarios.

- 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.

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- 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, tailored, as appropriate, to the type of customer.
- All charges involved in the purchase of the product should be disclosed, ideally on an unbundled basis (*i.e.*, a breakdown of the components of the total price).
- If the secondary market is non-existent, the customer should be told ahead of time how any repurchase price will be computed (whether using models, or markets for similar products) and what the price represents (mid-market theoretical value, repurchase prices, etc.). Customers should also have information about how and when they will be able to sell the product; if the intermediary or one of its affiliates is the only purchaser, the customer should be so informed.
- Alternative investment products should be identified, if available.

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.

Suggested ways to protect a customer purchasing complex financial products on an unsolicited basis include:

- 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).
- Warning the customer that the transaction may not be appropriate or that it would be prudent to take investment advice.
- 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.
- The report suggests the option for regulators of 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.

Suggested means of implementation include:

- 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.
- 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.

- Intermediaries should have a robust process to assess the profile of a customer for whom a suitability determination would apply.

- 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 taking into account, when providing individual portfolio management or advice, the composition of the customer's portfolio. The report notes that this is the equivalent of what is termed, in some jurisdictions, "reasonable basis suitability"; that is, the intermediary must determine that the product is at least suitable for someone.

- Intermediaries should perform their own due diligence analysis on complex financial products. Annex 2 to the report contains a list of issues that may be considered in an intermediary's due diligence investigation.

- Consideration should be given to possible less complex and less costly alternative investment products.

- Any suitability obligations apply to not only the intermediary but also its sales staff.

- If a complex financial product will be illiquid, 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. When 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.

- Any suitability assessment should take into account the duration and liquidity of the proposed investment.

- Intermediaries should document customer information required by regulators, and regulators should require intermediaries to retain those documents.

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.

Suggested means of implementation include:

- 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 prior to the intermediary recommending the purchase of such product.

- If a customer fails to provide the necessary information, the intermediary should be required to consider whether it can make a reasonably based recommendation. If the intermediary determines that it has insufficient information, then it should be prohibited from making the recommendation or providing the service to the customer, or, where permitted to make the recommendation, required to make clear that the recommendation is based on limited information and, in each case, to act in the best interests of the customer.

- Intermediaries should not recommend complex financial products that they do not understand.

- As in the last bullet of the means of implementation of Principle 4, regulators should be granted the power to prohibit or restrict automatically, when there are substantial investor protection issues, the recommendation of certain categories of more risky or complex financial products to certain categories of customers, such as retail investors.

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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.

Suggested means of implementation include:

- 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. These processes and procedures should be effectuated by enforced written strategies, processes and controls.

- Intermediaries should establish appropriate ongoing internal processes for identifying, periodically reviewing and approving or rejecting products so that they will be suitable for prospective customers.

- The compliance function should verify that these internal processes and procedures are properly functioning.

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.

Suggested means of implementation include:

- Intermediary and staff compensation policies should be designed to ensure that only suitable complex financial products are recommended to the customer.

- Senior management should be responsible for regularly reviewing incentive schemes and distribution practices by sales staff.

- 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. 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.

- 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.[2]

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.

[2] Since the end of 2012, such commissions are generally prohibited for retail investment advice in the U.K. At some time in the future, under the current proposals for MIFID II, such commissions will be banned in the EU, at least in respect of financial advice for retail customers that purports to be independent.

Suggested means of implementation:

- The regulatory system should supply strong and effective incentives for compliance.
- On and off-site visits and thematic reviews should be employed to ensure that appropriate internal processes have been put in place.
- Regulators should give consideration to how intermediaries address and resolve customer complaints.

Conclusion

The IOSCO report echoes concerns about sales of structured products raised by FINRA and the SEC, particularly with respect to retail investors. FINRA has spoken extensively about suitability, and the SEC has raised concerns about disclosure. Unlike U.S. regulators, however, the IOSCO report suggests that regulators (presumably in merit-based jurisdictions) should be given the option to restrict sales of certain structured products to retail investors or to ban them completely. This recommendation of the IOSCO report can already be seen in the approach of European policy makers and regulators, where the soon-to-be-established Financial Conduct Authority in the U.K. will be given broad powers in respect of financial products, including the power to ban products. Similarly, the proposed MIFID II legislative package would give intervention powers (including banning) in respect of financial products to the European Securities and Markets Authority, as well as to the national regulatory authorities of EU member states.

Author

Bradley Berman
New York
(212) 336-4177
bberman@mofo.com

Contacts

Peter Green
London
4420 7920 4013
pgreen@mofo.com

Jeremy Jennings-Mares
London
4420 7920 4072
jjenningsmares@mofo.com

For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkts.

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