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Complex Financial Products – International Support for yet More Investor Protection

By Jim Bulling

The International Organisation of Securities Commissions (IOSCO) has recently released its final report on "Suitability Requirements with respect to the Distribution of Complex Financial Products" (Report), which outlines the key principles in respect of the distribution of such products by intermediaries to retail and non-retail customers (wholesale clients).

While the recommendations of IOSCO are not binding on securities regulators, they do provide insights into how the Australian Securities and Investments Commission (ASIC) may approach guidance on similar issues.

Complex Products

The Report broadly defines "complex financial products" as financial products, whose terms, features and risks are difficult to value and are not reasonably likely to be understood by a retail customer because of their complex structure. Examples of "complex financial products" include, but are not limited to, structured instruments, hybrid instruments and financial derivative instruments (eg credit default swaps). The term does not include conventional equities, conventional bonds, simple vanilla unit trusts and mutual funds and exchange-traded standardised derivatives contracts.

IOSCO notes that whilst "complex financial products" may not pose a greater risk than standard vanilla financial products, "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".

The Report suggests that where a "complex financial product" is involved, intermediaries should:

- communicate information in a fair, comprehensible and balanced manner
- take reasonable steps to ensure that any recommendations, advice or decisions on behalf of a 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"
- where a potential risk of damage to the customer's interest exists, risks should be clearly identified to the customer
- establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability requirements (including when selecting new complex financial products for clients)
- develop and apply appropriate incentive policies to ensure that only suitable complex financial products are recommended to customers.

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The Report suggests that where a customer purchases a "complex financial product" on an unsolicited basis (ie no advice or recommendation), there should be appropriate and adequate regulatory systems in place to protect investors, including warning the customer that the transaction may not be appropriate.

Some of the recommendations in the Report align with recent ASIC guidance on hedge fund disclosures, namely Regulatory Guide 240 "Hedge funds: Improving disclosure" (RG 240). RG 240 provides guidance on the steps necessary to improve disclosure requirements on complex investment strategies, ie hedge funds.

Classification of Customers

The Report also recommends that intermediaries should be required to adopt policies and procedures that enable them to more clearly distinguish between retail and non-retail customers when distributing "complex financial products".

The Report provides guidance on the possible criteria to be considered when assessing whether a customer is a retail or non-retail customer including:

- nature of the customer
- financial position of the customer
- expertise, experience and knowledge in respect to the complex financial product
- ability of the customer to assess independently or with the assistance of an independent adviser the value and features of the relevant product.

Further, where an intermediary becomes aware that the customer is no longer a non-retail customer, they "should be required to take appropriate action with respect to any subsequent transactions".

Concerns about the definition of a retail customer and whether investors are being inappropriately classified as wholesale clients and therefore, being deprived of the protections provided to retail clients, is also a live issue in Australia. As part of the Future of Financial Advice (FOFA) reforms, the Government announced that there will be a review of the appropriateness of the criteria used to distinguish between wholesale and retail clients.

An options paper titled "Wholesale and Retail Clients Future of Financial" was released by the Australian Government in early 2011 which sought feedback from stakeholders on a range of options for the classification of clients as retail or wholesale. The proposed options seek to amend the definition of wholesale client to broaden the class of investor that would be captured as a "retail client" and hence be subject to more stringent regulatory requirements. There have been no reported developments on the Options Paper since its release.

However, with the recent collapse of Banksia Securities, the chairman of ASIC, Greg Medcraft stated that disclosure is no longer effective to protect investors and accordingly proposed that investors should be required to pass an online exam in the form of an "e-learning module" before investing in complex or risky products. Mr Medcraft stopped short of saying that such a test should be made compulsory but was advocating that the online exam should become "best practice" for all investments in complex or risky products.

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As a result, Mr Medcraft's comments following the collapse of Banksia Securities have received support from the IOSCO Report and testing of investor expertise, experience and knowledge may well become yet another component of financial services regulation to supplement the already extensive consumer protection mechanisms contained within the FOFA reforms.

Irrespective of the wishes of regulators, whether consumers support the notion of having to prove their expertise to their investment adviser remains to be seen.

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