

# Structured Thoughts

*News for the financial  
services community.*

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## **Complex Financial Products: IOSCO Suitability Requirements**

The Technical Committee of the International Organization of Securities Commissions (IOSCO) published a Consultation Report on 21 February 2012 on suitability requirements for the distribution of complex financial products.<sup>1</sup> IOSCO's intent is to propose minimum principles to be observed by intermediaries in assessing the suitability of structured investment products for their customers, so as to reduce the risk of mis-selling.

From a survey of its members, IOSCO has concluded that most jurisdictions already have developed requirements relating to determining suitability of investment products generally, but the focus of this Consultation Report is specifically on complex financial products (as defined below). Despite the complexity of a product not necessarily bearing any relation to its riskiness, IOSCO considers that the complexity of a financial product will typically affect how easy it is for the investor to understand the risk/reward profile associated with the product. The Report therefore proposes nine principles to ensure robust investor protection in respect of the distribution of complex financial products to both retail and non-retail investors. Distribution in this sense is given a broad meaning and includes not only the sale of such products, but also investment advice and recommendations, as well as the exercise of investment management discretion which results in investors holding such products.

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<sup>1</sup> "Suitability Requirements with respect to the Distribution of Complex Financial Products," February 2012, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD373.pdf>.

In Europe, the Markets in Financial Instruments Directive (MiFID) already requires the providers of investment advice or portfolio management services in relation to financial instruments to take steps to assess the suitability of the instrument for certain clients. Such steps include an assessment of the client's knowledge and experience in relation to such types of instrument, its financial situation and its investment objectives. For other types of service in respect of financial instruments, the firm must assess the appropriateness of the investment for the client, based on an assessment of its knowledge and experience. However, in practice, for both the suitability (other than in the case of portfolio management) and appropriateness assessments, European firms are permitted to assume that a non-retail investor already possesses the requisite knowledge and experience.

This means that in practice, in Europe, the suitability and appropriateness obligations in respect of non-retail clients are significantly reduced or even obviated altogether. However, IOSCO expresses concerns over the distribution of certain complex financial products to clients who may be non-retail clients but who nevertheless do not possess the financial sophistication of institutional investors, and it therefore proposes an approach of assessing suitability for both retail and non-retail customers, based on individual assessments of the client's levels of sophistication in respect of such investments.

For the purpose of the Report, IOSCO has provided definitions of the following terms used:

"complex financial product" – a financial product whose terms are not likely to be understood by an average retail investor,<sup>2</sup> where the product has a complex structure, is difficult to value without specific skills/systems and/or has a very limited or no secondary market and is therefore potentially illiquid.

"intermediary" - a firm that is in the business of managing portfolios, providing investment advice, executing orders on behalf of third parties and dealing in or distributing securities (although for the purpose of the US securities sector, it refers only to registered broker-dealers). It also expressly includes product providers to the extent that they distribute their own products.

"suitability" - any standard or requirement that an intermediary is expected to comply with in the distribution of financial products to assess whether the product matches the customer's financial situation and needs. It may involve an assessment of the customer's investment knowledge, experience, investment objectives, risk tolerance, time horizon, capacity to make ongoing contributions or meet collateral requirements and its understanding of the product in question. Suitability in this context includes also "appropriateness" from a European point of view.

### **The Aim of the Principles**

The particular risks prompting IOSCO to develop the suitability principles are:

- that certain customers may invest in products that they do not understand or which are inconsistent with their risk appetite or investment objectives;
- that certain complex financial products may be illiquid and difficult to sell;
- that the product may involve a leveraged component which may multiply the risk; and
- that where a product is manufactured by the intermediary itself, then the incentive for the intermediary to sell its own products provides a potential conflict of interest in terms of it assessing the suitability of the product for the customer.

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<sup>2</sup> It is worth noting that the recent FINRA Notice on Complex Products in the US, while it does not seek to propose a definition of a complex product, does include the likely lack of understanding of an average retail investor as a possible characteristic indicating complexity. See Morrison & Foerster Structured Thoughts Vol. 3, Issue 1, <http://www.mofo.com/files/Uploads/Images/120119Structured-Thoughts.pdf>.

## The Proposed Principles

### Customer Classification

*Intermediaries should employ 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, taking into account the complexity and riskiness of different products and services.*

More specifically, IOSCO has suggested that the categorisation of a customer as retail or non-retail could involve the nature of the customer (e.g. whether it is acting as a consumer or in a business capacity), its financial status, its financial experience in both the financial sector generally and with the particular product or asset class in question, and its ability to assess (independently or through an independent adviser) the value and risks of the transaction.

IOSCO is concerned in particular that certain entities have, in some jurisdictions, previously fallen within the definition of non-retail customers, and therefore been presumed to have a certain level of sophistication, but in practice have had an insufficient understanding of some complex products. It cites, as an example, customers such as local authorities and municipalities and urges different jurisdictions to consider whether additional protections should be required for public sector entities. It is worth noting that the current draft proposals for amendments to the MiFID directive, known as MiFID II,<sup>3</sup> provide that local authorities will no longer automatically be considered as non-retail clients.

IOSCO also proposes that a customer who qualifies as non-retail under a jurisdiction's regulations should still be allowed to request re-classification as a retail customer. This concept of a customer being able to opt into a higher bracket of customer care is also reflected in the MiFID directive in Europe.

The exact purpose of this proposal to categorise clients based on the terms "retail" and "non-retail" when distributing complex financial products is not easy to fathom. For one thing, it is not clear whether this categorisation is intended to use the same, or different, criteria than the definition of "complex financial product" itself. Since a complex financial product is defined as one which an average retail customer is not likely to understand, it is first necessary to determine who is a retail customer for the purpose of the definition of complex financial product. Seemingly, it is only then that it is possible to determine what duties should be owed by intermediaries.

Given the global nature of markets for many investment products, it would also seem essential for there to be global convergence on the meaning of "retail" and "non-retail" in this context.

### Fair dealing

*Intermediaries should act honestly, fairly and professionally in the distribution of complex financial products, and should take reasonable steps to manage conflicts of interest.*

This principle is intended to apply to all customers, irrespective of their classification as retail or non-retail, and even to counterparties who in some jurisdictions are not owed some or all of the suitability obligations.

As such, it is consistent with the current proposal in the draft MiFID II legislation that provides for investment firms to act honestly, fairly and professionally even with eligible counterparties (the most sophisticated category of client under MiFID) and communicate with them in a way which is fair, clear and not misleading.

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<sup>3</sup> See Morrison & Foerster client alert "Higher, Wider, Deeper: EU Commission Publishes MiFID II and MiFIR Proposals", <http://www.mofo.com/files/Uploads/Images/111031-EU-Publishes-MiFID-II-MiFIR.pdf>.

## Disclosure

*Investors should have access to material information to evaluate the nature, costs and risks of the complex financial product, and information should be communicated by intermediaries in a fair, comprehensible and balanced manner.*

In IOSCO's view, this would involve information on complex financial instruments presenting a balanced picture of the risks and potential benefits of the product, especially when the product's performance is sensitive to extreme scenarios. Equally, it states that the assumptions used for performance scenarios should be reasonable and conservative – not over-stating the benefits or under-stating the risks.

Stricter disclosure requirements should apply where the intermediary is providing investment advice or recommendations, and IOSCO also recommends that, for customers who fall within the definition of non-retail customers, but may not have the level of sophistication of an institutional investor, stricter standards of disclosure should apply than for other non-retail customers.

IOSCO states that any compensation or fee payable to the intermediary as a result of distribution of a complex financial product should be properly disclosed to the customer, who should have reasonable access to information allowing them to track the costs and charges related to the purchase of a complex financial product – ideally on an “un-bundled” basis.

In addition, where there is no liquid secondary market for a product, the customer should have access to information which allows them to know that the product is illiquid.

In terms of the form of disclosure for complex financial products, IOSCO urges the use of a simplified, user-friendly format, summarising the key features of the product, particularly where the product carries risks that may not be readily apparent to customers. In Europe, such a simplified format is already required to be employed in the distribution of units in UCITS investment funds, and the European Commission is expected shortly to introduce legislation requiring a similar concept of “key investor information disclosure” for all packaged retail investment products, known as PRIPs.

## Non-advisory services

*Regulation should provide adequate means to protect customers from risks associated with complex financial products, even when they are sold by an intermediary without the provision of advice or recommendations.*

In this context, IOSCO proposes that possible additional client protection could include imposing specific requirements, such as:

- requiring written approval to open a trading account for such products;
- requiring the intermediary to assess the suitability of a service that could give access to trading complex financial products, before recommending that service to a customer; and
- automatically prohibiting or restricting the distribution of certain categories of more risky or complex products to certain categories of customers (e.g. retail customers).

## Advisory Services

*Before recommending or advising on a complex financial product, or exercising investment management discretion in that regard, the intermediary should be required to take reasonable steps to ensure that its recommendation, advice or decision is based on a reasonable assessment that the structure and risk/reward profile of the financial product is consistent with the customer's experience, knowledge, investment objectives, risk appetite and capacity for loss.*

Given the greater reliance of customers on any recommendations or advice provided, or on the exercise of a manager's discretion in the context of investment management, IOSCO considers that stricter protections should apply to the provision of such advisory or discretionary services. It envisages that the regulatory system should require suitability obligations from intermediaries, calibrated to the complexity and riskiness of the product and the customer's level of sophistication. It considers that regulators should look at the circumstances and the behaviour of the intermediary as a whole, such that if its behaviour amounts to making a recommendation to a customer, it should not be able to avoid an obligation of suitability assessment by claiming that it has not made a recommendation to a customer.

In the context of advisory services, intermediaries should have robust processes to assess a customer's investment objectives, risk tolerance and risk preferences, its financial situation and capacity to absorb losses and its investment experience and knowledge. As part of these processes, intermediaries are expected to keep a written paper trail of the information required to be collected from customers.

IOSCO also makes the point that in order for an intermediary to be able to conduct a proper suitability assessment, it must itself have a thorough understanding of the features of the relevant financial product, and its complexity and associated risks. In this regard it expects intermediaries to perform their own analysis, considering issues such as how the product is structured and priced, its underlying components, the relevant level of risk, the level of liquidity, the fees or charges associated with the product and the nature of any guarantees.

Where a liquid secondary market for the product does not exist, intermediaries should draw this fact to the customer's attention, and where applicable, assess the fair value of the product through methodologies and modelling generally accepted in the market.

### **Obtaining sufficient customer information**

*An intermediary should have sufficient information on which to base any recommendation, advice or exercise of discretion in connection with the distribution of a complex financial product.*

IOSCO notes that in some jurisdictions, such as the US and in Europe for the securities sector, an intermediary would be prohibited from making a recommendation if a customer has failed to provide all the information requested by the intermediary. By contrast, in other jurisdictions, the intermediary would still be permitted to recommend the investment in these circumstances, but be required to make clear that it is based upon limited information.

In either case, IOSCO considers that the intermediary should be required to act in the best interests of the customer, although it expressly states that this does not necessarily imply a fiduciary standard on intermediaries in all instances. However it does mean an intermediary is at least making reasonable efforts to obtain the necessary information for a proper assessment of suitability and not encouraging a customer to engage in a transaction that is unsuitable for it.

IOSCO further notes that regulators can always consider an automatic prohibition or restriction on recommendations of certain categories of more risky or complex financial products to certain categories of customers, as a way of mitigating any risk of mis-selling.

In the draft MiFID II legislation, there are broad powers proposed for national competent authorities and for the European Securities and Markets Authority to ban or restrict the selling of financial instruments in appropriate circumstances, and, in addition, the FSA in the UK has recently outlined its proposals for a much more intrusive approach to financial regulation, which could include, amongst other things, the banning of products or certain product features.<sup>4</sup>

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<sup>4</sup> See Morrison & Foerster client alert "Product Intervention in the UK and the New FCA", <http://www.mofo.com/files/Uploads/Images/110705-Product-Intervention-in-the-UK-and-the-New-FCA.pdf>.

## Compliance Function

*In order to ensure suitability obligations are observed, intermediaries should be required to establish a compliance function, as well as appropriate internal policies and procedures.*

In particular, when developing or selecting new complex financial products for distribution, intermediaries should establish internal processes to ensure the compatibility of the product with the characteristics and needs of the target audience. The compliance function should, in turn, verify that the internal processes are functioning properly.

## Incentives

*Intermediaries should seek to eliminate incentives for their staff to recommend unsuitable complex financial products to customers.*

IOSCO considers that where complex financial products are more lucrative for an intermediary than selling less complex products, this can create incentives to sell complex financial products in unsuitable situations. It also considers in this context that the charges associated with complex products can be harder for investors to understand. Therefore, it recommends that intermediaries' staff compensation policies should actively discourage the recommendation of complex financial products which are unsuitable for the particular customer, and that senior management should take responsibility for regularly reviewing the incentive schemes and distribution practices by sales staff.

It also recommends that regulators should consider requiring disclosure to customers of remuneration structures and policies.

In this context, it is worth noting that under the UK's Retail Distribution Review, investment advisors to retail clients will, as from 1 January 2013, be prohibited from receiving any commission or fees from third parties in relation to packaged investment products they advise on. Similarly, under the draft MiFID II proposals, payment of such commissions and fees by third parties will be prohibited to investment advisors who purport to provide independent advice.

## Enforcement

*Regulators should examine intermediaries on a regular basis to ensure compliance with their suitability and other customer protection obligations, with respect to complex financial products.*

In particular, IOSCO envisages that on-site and off-site visits should be conducted, as well as thematic reviews, to monitor intermediaries' internal processes and compliance procedures in this regard.

IOSCO emphasises that competent authorities should take action, as appropriate, to enforce compliance as well as considering whether to make such enforcement actions public, for the protection of investors.

## Next Steps

Regulatory authorities in several jurisdictions, including the US, France, Belgium and Denmark, have in recent times been focusing their supervisory activities on the complexity or otherwise of an investment product. In addition, the draft MiFID II legislation proposes to bring more products within the scope of the appropriateness assessment, by deeming them complex, and therefore outside the "execution-only" exemption from that assessment. Although complex products have never been permitted to be sold under the execution-only exemption, the current MiFID II legislative proposals still propose to retain the ability for a firm to presume that a non-retail investor has the requisite knowledge and experience to invest in a product and therefore the IOSCO principles will give rise to some tension in relation to complex products being sold to non-retail investors. Whether the complexity of a product is the most appropriate regulatory focal point in any case, or whether it should be another consideration, such as the product's

risk/reward balance, remains a topic of intense discussion and it will be interesting to see how this develops through the responses on this Consultation.

IOSCO has invited comments on the Consultation to be received on or before 21 May 2012.

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