

March 11th, 2011

Stephen Po
Senior Director, Intermediaries Supervision
Securities and Futures Commission
8th Floor, Chater House,
8 Connaught Road Central,
Hong Kong

Dear Stephen,

Joint Industry Written Contribution on Suitability Requirements for Market Intermediaries in Relation to Investors

At the meeting between IOSCO Standing Committee 3 – henceforth ‘SC3’ - and interested parties on December 3, 2010, you said that ahead of the next meeting of the Standing Committee (now scheduled for late March as we understand), it would be helpful to have a written contribution from the industry on the issues raised.

This letter and attached annexes constitute the written contribution of the Institute of International Finance, the International Banking Federation, and the Joint Associations Committee on Retail Structured Products, (the JAC)¹ together ‘the Associations’.

General Approach

The work of SC3 in this area stems largely from concerns over misselling of financial products, highlighted by the Joint Forum in its survey of suitability standards; the G-20 mandate to IOSCO to promote financial market integrity by reviewing business conduct rules; and IOSCO’s 2009 report on *Unregulated Financial Markets and Products* recommendation that IOSCO should review investor suitability requirements as well as the definition of sophisticated investors and strengthen these requirements as appropriate. The Associations note that SC3 has therefore been examining the issue of suitability standards for the sale of complex financial products both with regard to retail and non-retail investors.

¹ The JAC is sponsored by multiple associations with an interest in structured products: the International Swaps and Derivatives Association (ISDA), the International Capital Markets Association (ICMA), and the Association for Financial Markets in Europe (AFME). In the first instance, queries on the JAC may be addressed to rmetcalfe@isda.org.

The Associations both understand these concerns on investment protection and financial market integrity and support work on international principles to address them. It is of absolute importance that investors of all levels of sophistication and capability be treated fairly, honestly, efficiently and professionally, and appropriate standards on suitability analysis are essential to the pursuit of those goals.

The Associations therefore very much welcome IOSCO's engagement on this important issue. We would argue however that there is a further public policy interest in addressing this issue: that of mitigating any potential damage to investor protection from different or divergent national or regional approaches on these issues. Indeed, the Associations would very much encourage further work on convergence in these areas, which will become increasingly important in the years to come as markets continue to globalize and investors of all levels of sophistication and capability seek investment opportunities both in their home jurisdictions and beyond.

The Associations are therefore determined to engage in the most constructive and reasonable way possible on the issue both in offering observations to IOSCO and in acting to promote industry sound practice. We hope therefore that this initial contribution will be seen in this regard.

Whilst the Associations recognize that the immediate focus is and should be on suitability requirements, the Associations believe that it will be important to proceed to develop common global standards on client categorization in relation to offering restrictions, conduct of business rules and licensing requirements. In this regard, the Associations recall that the IIF and the Securities Industry and Financial Markets Association (SIFMA) wrote to the then Chairman of the IOSCO Technical Committee, Michel Prada, in October 2007 calling, *inter alia*, for convergence of investor categorization regimes and believe that the arguments in that letter are still valid. This would also be very much in line with the G-20 mandate to IOSCO on business conduct standards.

The Lessons of the Crisis

Whilst the Associations recognize the concerns of SC3 members over complaints from investors in certain jurisdictions since the financial crisis, the evidence available suggests that what actually happened was more complex and varied than simple misselling of products to investors (although that occurred in certain instances) and analysis of the issues must include consideration of a number of factors including:

- i. Instances where there was indeed misselling in the sense that products were inappropriately or inadvertently **marketed** to investors without due regard to their level of sophistication or capability, leading them to believe that particular products were suitable;
- ii. Instances of **inadequate disclosure** by either product originators or market intermediaries to investors, including where the disclosure did not fully cover the market risk and default risk and more generally failed to set out the worst-case scenario;
- iii. Instances where, despite requirements, the intermediary did not obtain **sufficient or updated information** about the knowledge, experience, or investment time horizon of investment of the client to enable it to give sufficient advice on the suitability of a potential investment;

- iv. Cases where there were adequate rules but where **enforcement** was lax or did not pick up breaches by individual intermediaries or providers;
- v. Cases, particularly for more sophisticated or capable investors, where marketing and disclosure was adequate, where the investor did not receive misleading or inappropriate advice, but where the investor either did not carry out **sufficient due diligence** with regard to the risks that they were undertaking or consciously made a decision to overlook the risk of default or weaker performance even though they were in a position to do so;
- vi. Cases where a client involved in an **execution-only** relationship with a broker ordered the purchase of an instrument, in a context where the broker did not have any duty of advice to the client, and did not make any assessment of the suitability of the particular product for the client, not being required to do so; and
- vii. There were cases where the **credit ratings** attached to certain products may have given an incomplete or possibly misleading picture of the risk of a particular product and where investors did not carry out an independent assessment and diligence, relying on the rating alone. We note that concerns were highlighted even before the height of the financial crisis, including in the *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations* of July 2008.

Moving Forward

In adopting a common approach therefore, the Associations believe that IOSCO should be mindful of this complexity and should take a **careful, targeted and proportionate** approach in developing common standards on suitability requirements.

In particular, the Associations do not believe that IOSCO should define its analysis of suitability issues around **complex products**. Such an approach would be difficult to implement and administer for regulatory authorities, firms and customers. For example, complexity does not always mean additional risk and conversely, some non-complex products may be higher risk. We believe that a more effective approach would be to look at all securities, collective investment schemes and related derivatives instruments and the balance of risk and reward associated with them.

The Associations also believe that any IOSCO approach should be ‘business model-neutral’ in that it should not prohibit, mandate or promote particular types of products or business models. We note that the US Securities and Exchange Commission (SEC) in its recently published ‘*Study on Investment Advisers and Broker-Dealers*’ endorsed this neutrality.

In moving to such a common approach, the Associations feel that it is useful to go beyond addressing the concerns on investor protection, financial market integrity and regulatory fragmentation and make clear the **outcomes** that international standards and industry practices should achieve. We would suggest the following:

- The recipient of a financial service or product should be in a position to understand the service or product in all material respects including its risk-reward profile or be represented by an agent who can understand the service or product.
- The decision to buy a financial service or product should not be influenced by a material conflict of interest on the part of the provider or advisor.
- A recipient of personal recommendations should expect the provider to take reasonable care in the provision of that investment advice.

The Associations believe that any approach should take account of the diversity and dynamism of the market for investment products. It should also take account of the gradations in sophistication or capability of investors and strike the right balance between adequate investor protections and the recognition of the duties of investors in the conduct of their own investment.

Investors of a similar level of actual sophistication or capability should be afforded a similar, appropriate minimum level of protection in taking on an investment exposure of a given sort regardless of the number and relative roles of the firms involved in the process by which an exposure (having been put into a investment form) is provided to the investor. However, this principle needs to be qualified by reference to the services a particular investor selects – in particular, the fact that some investors will not want investment advice or, where they do, will not seek to establish an ongoing relationship.

The Associations also believe that, in defining appropriate levels of protection, IOSCO should be mindful of a number of different factors:

- **Diversity of products:** there is a considerable variety of investment products, some offering similar returns, but through different legal structures. It does not necessarily follow that an investment product with a relatively complex legal structure will also have a complex risk/reward profile or vice versa.
- **Diversity in the ways in which an investment exposure is assumed:** any approach should take full account of the many different avenues by which investment exposures are mediated to customers and the differing roles played by financial institutions in each - whether in the design of an index, structuring an investment product, arranging for its issue, managing the portfolio of assets associated with it, assisting a person to acquire it or advising a person on whether to do so. In some cases, only one firm is involved in an “end-to-end” process (for example, this more likely with life assurance or structured deposit products). In others there could be many firms involved, and not all of them will necessarily be subject to the regulatory oversight of a single regulator or even located in the same jurisdiction. Among other things, it cannot be assumed: (a) that a firm engaged in product design necessarily knows who will ultimately acquire the product or have any direct relationship with investors; or (b) that a firm that sells a product will necessarily be appointed to give advice or have any continuing relationship with the investor – the investor may appoint it to do these things, but equally the firm may only be asked to execute a trade.
- **Phases in the distribution process:** in spite of the diversity highlighted above, from the point at which a product has been created, there appear to be three basic phases for the

distribution process: **pre-sale** (marketing, disclosure, information gathering on the investor); **point of sale** (advice, execution of orders); and **post-sale/ongoing duties** both with regard to the sale of an individual product and arising from an account relationship. There are also requirements or duties that should operate at all stages in the process.

- **The fact that there are different types of participant:** not only investors and market intermediaries but also product originators, packagers and issuers.

Looking at each of these factors in a sequential way can however lead to a great deal of confusion and a loss of perspective. Instead the factors need to be seen as gradations within an overall framework. A possible way of looking at this is set out in Annex 1.

Whilst the central focus of IOSCO's suitability work is clearly the point-of-sale phase and to a lesser extent, the ongoing obligations of market intermediaries in respect of changes in the performance or value of the product, as indicated above, the Associations believe that the broader context is critical in calibrating the intensity of regulation required.

Principles

In looking at how best to respond constructively to IOSCO on this issue, the Associations concluded that there would be value in suggesting principles to capture this complexity and in particular the different duties of different participants. Such principles could guide both conduct by market intermediaries towards investors and the aims of regulation in this area.

We attach such a set of possible principles in Annex 2, prepared with the input of industry experts from around the world and constituting some initial thinking to assist IOSCO in its deliberations on suitability requirements. These are very much preliminary suggestions but should help address the concerns of investors and IOSCO members, leading to improved investor protection.

The Associations believe that the Principles could apply to all forms of securities, collective investment schemes and related derivatives instruments referred to in the Principles as "investments". They should apply whenever a firm deals or provides services in relation to investments with or for a person on whose behalf it is acting.

The Principles should be applied in a way that recognizes the relative sophistication, capability and ability of the customer concerned to bear investment loss. However in doing so, there must be recognition (i) that customers' investment decisions are dependent on a range of factors, not all of which are within the sphere of influence of intermediaries; and (ii) that customers have ultimate responsibility for their own investment decisions.

Conclusion

The Associations both welcome and support IOSCO's engagement in this area. Global standards both here and on the linked issue of client categorization would be in the interests of investor protection and financial market integrity. As noted above, it is of absolute importance that investors

of all levels of sophistication and capability be treated fairly, honestly, professionally and efficiently. Appropriate standards on suitability analysis are essential to the pursuit of that goal.

The Associations have therefore been determined to engage in the most constructive and reasonable way possible, whilst reflecting the complexity of the issue and promoting a careful, targeted and proportionate approach. We hope that the attached Principles and Framework Matrix will assist in delivering this and with achieving the desired outcomes set out above.

We would be very happy to discuss with SC3 if desired and to explain further the Principles, Framework Matrix and underlying approach. If you have any questions do not hesitate to contact either Richard Rosenthal – Richard.Rosenthal@morganstanley.com – or Crispin Waymouth – cwaymouth@iif.com.

Yours faithfully,



Mr. David Schraa
Director, Regulatory Affairs
Institute of International Finance



Mrs. Sally J. Scutt
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International Banking Federation
British Bankers' Association



Mr. Timothy J. Hailes
Chairman
Joint Associations Committee

cc: Raffaella Pantano, CONSOB, Chair of Suitability Working Group, IOSCO

Greg Tanzer, Secretary-General, IOSCO

Hans Hoogervorst, AFM, Chair, IOSCO Technical Committee

Steven Maijoor, Chairman, ESMA

Maria Velentza, Head of Unit, Securities Markets, European Commission

Ethiopsis Tafara, Director, Office of International Affairs, Securities and Exchange Commission

Jacqueline Mesa, Director, Office of International Affairs, Commodities Futures Trading Commission

Attachments:

Annex 1: Framework Matrix

Annex 2: Principles