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Comments by the International Swaps and Derivatives Association (**ISDA**) and the Securities Industry and Financial Markets Association (**SIFMA**) on:

- The Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies dated 31 December 2008; and
- The Securities and Futures Commission: Issues raised by the Lehmans Minibonds crisis. Report to the Financial Secretary dated December 2008.

17 April 2009

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Dear Sir/Madam,

The International Swaps and Derivatives Association (ISDA) and the Securities Industry and Financial Markets Association (SIFMA)[1] appreciate the opportunity to collectively express our views on the following:

(i) Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies dated 31 December 2008 (the "**HKMA Report**")

(ii) Securities and Futures Commission: Issues raised by the Lehmans Minibonds crisis. Report to the Financial Secretary dated December 2008 (the "**SFC Report**" and, together with the HKMA Report, the "**Reports**").

As the two Reports deal in the same subject matter and, in a number of areas, make broadly similar recommendations, we will address both Reports in this letter.

Executive Summary

The objective of the Reports "is to provide information and observations for the purpose of a review by Government of the existing regulatory regime and investor protection framework applicable to the sale to retail investors of Lehman Brothers Minibonds and other structured products akin to Minibonds"[2] ISDA and SIFMA fully support this undertaking and are committed to re-building confidence in the structured products market, including working with our respective members to assist in reviewing and, where necessary, reinforcing the existing regulatory regime.

The existing regulatory regime and investor protection framework applicable to the sale of structured products to retail investors in Hong Kong rests on two important pillars: (1) a "disclosure" based regime for the making of informed decisions by investors, coupled with (2) a "suitability" requirement on the part of the selling intermediary to determine the suitability of the product for its client.[3] Such "two pillars" approach is consistent with that of all major jurisdictions in regard to the distribution of structured products, and we agree with the strong recommendations of both the SFC and the HKMA that it should be retained. The Reports set out in detail the potential undesirable outcomes in moving towards a more "merit-based" approach, and we discuss these in our letter below.

With regard to proposed amendments to applicable rules or regulations or other recommendations made in the Reports, we wish to highlight a few of these for discussion in this letter. In particular, we will provide comments on the following proposals:

(I) The preparation by the product provider of a summary or "Key Facts Statement" in relation to the offering of a structured product.

We support this, subject to our comments below.

(II) A "cooling-off period" for the purchase of structured products.

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[1] Descriptions of these associations are provided in Appendix 3.

[2] HKMA Report, paragraph 1, page 3.

[3] SFC Report, paragraph 2.2, page 2; HKMA Report, paragraph 8.1, page 58.

We are strongly opposed to this proposal, for the reasons below.

(III) The mandatory disclosure of all commissions received by intermediaries for offering or recommending a product.

We support this, subject to our comments below.

(IV) Provision by product providers (through intermediaries) to investors of (a) on-going secondary market price information and (b) notification of changes in circumstances that may have a significant effect on the value of the relevant product.

We support (a) subject to our detailed comments, but are strongly opposed to (b).

(V) Continuous monitoring by intermediaries of the "risk rating" of products sold by intermediaries and ongoing notification to existing customers if the risk ratings rise.

We support this, subject to our comments below.

(VI) Bringing forward requirements for intermediaries to adopt suitable criteria for characterising investors with a view to assisting in ensuring that investment advice and products offered are suitable for the investors.

We support this, subject to our comments below.

(VII) Appointing an Ombudsman to provide a clear, swift and cost-effective means of potential redress for investors.

We support this, subject to our comments below.

We would also seek to ensure that any proposed changes are generally only applicable in relation to offerings which are sold to retail investors in Hong Kong through offerings which are not exempt from the authorisation requirements under the Securities and Futures Ordinance and the prospectus regime in the Companies Ordinance.

In our comments, we will make frequent reference to applicable principles drawn from the following publications of the Joint Associations Committee (the "**JAC Principles**")[4]:

(i) Principles for managing the distributor-individual investor relationship regarding Structured Products (*reproduced at Appendix 1*); and

(ii) Principles for managing the provider-distributor relationship regarding Retail Structured Products (*reproduced at Appendix 2*).

Please note that this letter only touches on certain of the items discussed in the Reports; individual members will have their own views on aspects of the Reports and may provide such comments independently.

In keeping with its status as one of the world's leading financial centres, Hong Kong's market for structured products offers a sophisticated and diverse menu of choices to residents to help meet their own unique financial objectives in light of their particular circumstances. The challenge in reviewing the regulatory regime in response to the potential mis-sale of the Lehman Minibond product is to ensure that any new measures introduced do not have the unintended consequence of stifling the market as a whole and depriving investors of products which may be eminently suitable for them. To that end, the interests of the industry and of the Treasury and the regulators are aligned in ensuring that the lessons from this experience are well understood and serve to

[4] An association of five leading trade associations (International Capital Market Association (ICMA), International Swaps and Derivatives Association (ISDA), European Securitisation Forum (ESF), London Investment Banking Association (LIBA) and Securities Industry and Financial Markets Association (SIFMA))

focus the review of the regulations, whilst being careful to preserve a regulatory framework that is conducive to product innovation and future growth. If the regulatory review is conducted in such way, investors will be better protected, but yet have the opportunity to invest in an ever evolving suite of attractive and appropriate products to meet their particular investment needs.

Retaining the current "two pillars" approach to securities regulation of disclosure coupled with suitability obligations, instead of moving towards a "merit-based" system.

There is considerable discussion in both Reports as to the current structure of the regulatory regime for the sale of structured products in Hong Kong and whether there should be a change towards a merit-based approach. The current structure is described in the SFC Report[5]:

> "The regulatory structure for the sale of investment products rests on two important pillars – disclosure and suitability. The first of these is the responsibility of the SFC – to ensure that, based on the information provided by the product issuer, sufficient information is disclosed in the product documentation by the issuer to enable a reasonable person to make an informed decision. The second is the responsibility of the intermediary – that the product is suitable for the particular investor taking into account a full understanding of the client's profile and investment needs."

The HKMA describes the existing approach as follows[6]:

> "In its approach to providing an appropriate or reasonable level of investor protection, the regime adopts a <u>disclosure-based approach</u>, in common with many other jurisdictions. This essentially means that issuers are free to launch investment products so long as adequate disclosure is made to enable potential purchasers to take an informed investment decision. With the exception of collective investment schemes requiring authorisation from the SFC, Hong Kong does not adopt a system of <u>product</u> approval as a hurdle to issuance. 'Dealing in securities' is a regulated activity under the SFO and, where products are sold through intermediaries, the disclosure-based approach is underpinned by requirements at the point of sale for such intermediaries to act with skill, care and diligence and in their clients' best interests. Where intermediaries make a recommendation or solicitation in respect of a product, they must assess the suitability of the product for individual purchasers."

The "two pillars" approach is the predominant regulatory structure for structured products across all comparable jurisdictions. As the HKMA Report notes[7]: "...the US, the UK, and other European Union countries, Australia and Singapore, retain disclosure-based regimes".

In contrast, a "merit-based" regime requires all proposed offerings of securities to the public to be subject to prior review by the applicable regulator as to the investment merits of the offering. If, following such review, the regulator is of the view that such securities are not suitable for a public offering, then the offering will be prohibited. Accordingly, responsibility for a blanket ruling on suitability with regard to retail investors is placed on the applicable regulator.

Both the SFC and the HKMA came out unequivocally in their respective Reports in favour of retaining the existing "two pillars" regime and not moving towards a merit-based approach. We very strongly support this conclusion. As discussed in the Reports, moving towards a merit-based approach would have a number of very significant disadvantages and undesirable consequences. The following represents our distillation of the various arguments raised in the Reports, together with our additional thoughts on the potential negative repercussions of moving towards a merit-based regime:

1. ***It is not appropriate for regulators to assess the suitability or merits of a structured product in the abstract as against a "notional" retail investor: the***

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[5] SFC Report, paragraph 2.2, page 2.

[6] HKMA Report, paragraph 3.3, page 18.

[7] At paragraph 8.3, page 59.

assessment of the suitability of products can only be made as against a particular investor, with reference to that investor's own unique set of circumstances.

The term "structured products" covers a diverse array of instruments:[8]

> "'Structured Products' generally refer to products which, in addition to an exposure to the credit or default risk of the issuer (or guarantor where applicable), contain an exposure to an underlying asset, opportunity or risk that is usually unrelated to the issuer or the guarantor (Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance published by the SFC in September 2006)."

Structured products give investors the choice to invest in or otherwise take an exposure to different assets or risks such as equities, commodities, currency rates, funds, fixed income instruments, credit risk, interest rates, volatility and economic indices, which would not otherwise be separately available. In particular, structured products allow investors to take a directional view, such as to be short credit risk, that an investor could not easily replicate for himself. Structured products can also give investors choices on the timing and payment of interest and principal which would not be available through other asset classes. Structured products can be viewed as a necessary part of a diversified portfolio, particularly in today's market where many asset classes are moving in tandem and various classes of investors may be overexposed to products that were part of a bull market prior to the credit crisis.

The suitability of a particular structured product in respect of a particular investor depends upon the various features of such product in light of the unique circumstances of that investor, including the investor's financial situation and investment objectives. For example, many structured products are designed to include a capital protection feature - that is, the investor gives up part of his potential return for the predictability of his final return. Products of this kind are designed for investors with lower risk tolerances, and are likely to be unsuitable for investors who seek higher levels of return and higher levels of risk. As the SFC states[9]: "For almost every product it is possible to identify some investors for whom the product may not be suitable or for whom the product would only be suitable as part of a portfolio of investments."

Accordingly, requiring the regulator to make an initial determination as to the suitability of structured products for sale to retail investors would generally place the regulator in the exceedingly difficult position of having to make a blanket assessment of the various features of such product as against the spectrum of differing financial circumstances and investment objectives of the universe of potential investors. It might also have the effect of encouraging such investors to seek such products in other financial centres, potentially weakening Hong Kong's market position and even possibly putting those investors at greater risk in less well regulated jurisdictions with potentially more difficult means of seeking recourse in case of dispute.

2. ***As a corollary to point 1, there is a high likelihood that any determination by the relevant regulator resulting in the banning of a structured product for offer to the public would represent the loss to some investors of a legitimate investment opportunity suitable for such investors' particular circumstances.***

   In all likelihood, the effect of mandating the regulator to make an initial assessment of all structured products with authority to prohibit the offering of any such products where it deems that the product is unsuitable, will be to reduce the number of products offered to the Hong Kong public. In our view, this would be an unfortunate result for some investors, as it would deprive them of investment opportunities that may suit their particular investment profile.

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[8] Note 4, page 11 of the HKMA Report.

[9] At paragraph 24.4, page 48 of the SFC Report.

In its Report, the SFC notes that "[c]omplexity of the structure of a product does not necessarily mean that the product is an unduly risky investment in normal market conditions."[10] We strongly agree that, one should be careful not to assume that a structured product having complex features and intricate terms is, solely because of such complexity, an intrinsically high risk product and, as such, may not be suitable for retail investors. A false link is sometimes made between product complexity and product risk, which leads to the misconception that complex products are automatically high-risk products. This is clearly not the case - for example, adding a principal protection feature to a product may increase its complexity while at the same time reducing its risk. It is also sometimes suggested that complex structures are unsuitable because they cannot be easily understood. This is based on another fallacy - what investors need to understand is not the underlying structure of an investment, but the possible outcomes of investing in it, the costs and the risks inherent in it. In the retail structured product markets product complexity is often the result of products being structured to create more tailored - and quite possibly less risky - investment outcomes. The complexity of a structured product is not relevant in deciding whether to invest in a product – what matters is whether the investor understands the risks and the expected returns.[11]

Accordingly, reducing the available universe of structured products available to Hong Kong-based investors would deprive investors of products that could otherwise be beneficial additions to their respective investment portfolios.

3. ***As a further corollary to point 1 above, there is a risk that, where a regulator has authorised (or, at least, has not prohibited) a product for public offer, (i) intermediaries may wrongly assume that their own suitability obligations vis-a-vis investors have been usurped to some extent by the regulator and will not undertake as rigorous an assessment as they otherwise should and (ii) investors may falsely seize on such authorisation/non-prohibition as a de facto official "seal of approval" that the product is "low risk" and suitable for them and may not consider the merits of the product to the same degree as without such official imprimatur.***

The former concern is expressed by the SFC: "[w]e are concerned that establishing a process of product approval or risk rating by the regulator will erode Intermediaries' awareness of their obligations to ensure suitability".[12] The latter concern is described by the HKMA: "In such a [merit-based] regime, if a given product is not prohibited, a degree of moral hazard may even be induced by this fact, encouraging investors to buy without carefully considering the risks on the basis that it must be "safe" because it has not been banned."[13] We agree with the SFC and the HKMA that these are indeed valid concerns, and would add the further comment in respect of the first point that, in certain cases, investors may be less agreeable to providing all of the necessary information to distributors in order to make a suitability assessment if investors are of the view that such function has already been carried out by a regulator.

4. ***Given that investors may seek to rely on the approval (or non-prohibition) by a regulator in respect of a particular structured product, staff at the relevant regulator may require an explicit government indemnity against actions from disgruntled investors and/or legislation would need to be introduced providing for an explicit exclusion of liability in favour of such individuals in all circumstances.***

[10] At paragraph 16.3, page 33 of the SFC Report.

[11] Extracted in part from the submission by the JAC to the European Commission on 18 January 2008.

[12] SFC Report, paragraph 24.6, page 48.

[13] HKMA Report, paragraph 8.4, pages 59-60.

For this reason and others, it may be difficult to find qualified personnel to carry out merit-based review.[14]

5. ***The potential for a ban on the sale of structured products into Hong Kong – in contrast to the disclosure and suitability assessment approach generally carried out in most other major jurisdictions – could have an adverse effect on Hong Kong's leading position as an international financial centre.***[15]

In summary, consistent with the views of the SFC and the HKMA, we strongly support retaining the existing "two pillars" regulatory regime of disclosure coupled with a suitability assessment obligation.

Comments on specific proposals in the HKMA and SFC Reports

We set out below our comments in relation to a number of selected proposals from the Reports.

(I). A proposal for issuers of structured products ("product providers") to prepare a Summary or "Key Facts Statement" in relation to the particular product being offered ("Summary"). (*26.6 SFC Report, 8.10 and 8.14 HKMA Report*)

According to the HKMA:[16]

> "Few investors are likely to read a full prospectus. Therefore, consideration should be given to introducing short-form uniform disclosure formats for retail structured products (and the concept could be extended to other retail investment products). ... Something along the lines of two simple "Key Facts Statements" (of, say, three pages each maximum) in reasonable-sized print might be appropriate."

Similarly, the SFC states:[17]

> "We recommend that the SFC develops requirements for summaries to be prepared for all products offered to the Hong Kong public including CISs, ELNs, ELIs, equity linked deposits, insurance-linked assurance schemes, CLNs in no more than four pages of plain, concise easily understood language, augmented by charts and diagrams. These product summaries should: (26.6.1) include all key information; and (26.6.2) facilitate comparisons with other products."

We support the proposal to include a Summary or "Key Facts Statement" in relation to the offering of structured products. However, we have a number of concerns and recommendations as to the detailed requirements, as follows:

(a) ***A Summary should only be required for retail investors, and should not apply to offers made to professional investors.***

The purpose of a Summary is as an aid to disclosure for more vulnerable retail investors to more readily understand essential terms of the product given the length and complexity of prospectuses for investment products – particularly structured products. A Summary will add additional cost and risk to the prospectus, and should not be necessary for sophisticated investors or institutions (e.g. "professional investors"), as such investors should be expected to carry out a detailed review of the offering prospectus. Any requirement to prepare a Summary should not apply in respect of offerings which are exempt from the authorisation requirements under the Securities and Futures Ordinance and the prospectus regime in the Companies Ordinance.

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[14] See HKMA Report, paragraph 8.5, page 60.

[15] See SFC Report, paragraph 24.4, page 48

[16] At paragraph 8.10, page 62 of the HKMA Report.

[17] At paragraph 26.6, page 55 of the SFC Report.

In this context, we recommend that the nature and definition of "professional investors" is revisited and updated to take into account the various categories of "professionals" who should be catered for in this type of situation and in relation to other aspects of the Hong Kong regime.

(b) ***The prescribed content requirements of a Summary should be principles-based and not overly prescriptive, albeit clear guidance and template forms should eventually be made publicly available following a process of government-industry consultation and implementation should be delayed until completion of such process.***

We note the main content requirements of a prospectus prepared in accordance with the EU Prospectus Directive are that the summary of such prospectus "...shall, in a brief manner and in non-technical language, convey the essential characteristics and risks associated with the issuer, any guarantor and the securities..."[18] We suggest that such principles-based approach to the content requirement is preferable to detailed prescribed terms on various elements of the relevant investment product and terms of the offering.

Similarly, we would suggest to be careful not to adopt a rigid once-size-fits-all approach to securities offerings generally: different product "wrappers" carry with them different features, and therefore need to be described separately in the prospectus and in any related summary. For example a key disclosure item in regard to the offering of units in a managed fund may be the identity and track record of the fund manager, whereas key disclosure terms in regard to the offering of equity-linked notes may be the product payout formula and the credit risk of the issuer/guarantor. The Summary provisions should be appropriate and "fit for purpose" across all products and wrappers. Further, in relation to standardised products such as equity-linked investment contracts when the same structure could be issued on a daily basis with only variations in commercial parameters, we would urge that a general Key Facts Statement is required to be prepared for each structure only, and not tailored in respect of each series for differences in commercial parameters.

In our view, "best practices" for the preparation of a Summary should be determined in an iterative process, with the regulators giving regular and clear guidance through training workshops with documents from the product providers (where feedback can be given and taken on both sides), and during the approval process itself. We would be pleased to assist the HKMA and SFC in adapting the relevant principles towards the development of published guidance and product templates with a view to promoting consistency in disclosure standards and reducing uncertainty and removing ambiguity as to information and formatting requirements as well as facilitating investor comparisons between products.

The implementation of the requirement to prepare a Summary should be delayed until the consultation process is complete and published guidance and product templates are available. Further, this requirement should not be applied retrospectively.

(c) ***The Summary should not be subject to a prescribed page limit.***

Limiting Summaries to three or four pages is no guarantee that the Summary will be "clear, concise and comprehensible" and will not be "legalistic and overly long". A page limit is only a quantitative measure of a qualitative outcome.

Firms should have significant freedom to design Summaries which meet regulatory objectives and which their customers can understand, subject to the production of template Summaries as discussed in paragraph (b) above. Information density per page and formatting may be just as important as the number of pages.

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[18] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (the "**EU Prospectus Directive**"), Article 5(2).

There is less need for a page constraint where the regulator approves the Summary for readability. While it is true that more disclosure is not necessarily better, there is a case that less disclosure is not necessarily better either, especially if customers do not read the full prospectus.

There should be flexibility to allow for greater depth of explanation of new products or more complex products. An un-intended side effect of a low page limit may be that fears of legal liability could choke off the development of new or more complex products. For example, certain more structured products using Special Purpose Vehicles may give some investors a security package which is preferable to them, but it may be more difficult to adequately explain such products within a prescribed page limit.

(d) ***A Summary should be part of a prospectus (whether physically included in such document or as a separate document expressly stated to be read together with the prospectus), and there should be a statutory exclusion of liability in relation to the Summary save where it is materially misleading, materially inaccurate or materially inconsistent, when read together with the other parts of the prospectus.***

Both the SFC and the HKMA recognise in their respective Reports that a potential impediment to the production of clear, concise and brief Summary documents is the dual use aspect of prospectuses: i.e. that they serve to protect responsible persons from liability (provided that all materials information is disclosed in such document) in addition to their disclosure function. Mandating the preparation of a separate document, on non-legal terms, providing summarised disclosure of legal terms and limiting risks disclosure to "essential" risks only, will be resisted on the basis that responsible persons will be vulnerable to claims alleging omission or lack of sufficient detailed disclosure of material provisions in the Summary notwithstanding that such terms and risks may be set out in full in the main body of the prospectus. According to the HKMA: [19]

> "An issue that may arise in relation to Key Facts Statements would be a tendency for them to become legalistic and overly long, and used to protect product issuers rather than enlighten customers."

To alleviate this concern, we suggest that:

(i) the Summary be delivered with and constitute part of the larger prospectus, and be expressed to be subject to the terms of such prospectus and to be read with the prospectus;

(ii) for the avoidance of doubt, the Summary should only be a summary of information appearing in the main body of the main prospectus and there should be no additional disclosure requirements specific to the Summary; and

(iii) there should be a statutory exclusion of liability for responsible persons in relation to the Summary save where it is materially misleading, materially inaccurate or materially inconsistent, when read together with the other parts of the prospectus[20] – or such other narrow basis of liability as may be appropriate.

[19] HKMA Report, paragraph 8.11, page 63.

[20] See, for example, Article 5(2)(d) of the EU Prospectus Directive.

(II). A proposed cooling-off period for purchases of structured products, subject to either an "equitable adjustment" for changes in market value, or (in the case of the HKMA Report) a waiver of the cooling-off if safeguards are satisfied. (*4.6 and 32 SFC Report, 8.39 HKMA Report*)

We strongly urge against the introduction of a mandatory cooling-off period for the sale of structured products. Our reasons are as follows:

(a) ***A mandatory cooling-off period is not necessary***

As a matter of practice, if there is (i) a Summary or Key Facts Statement to assist retail investors to more readily understand the relevant product and (ii) suitable advice from the distributor to the investor in relation to the investment decision in accordance with existing rules, a cooling off period should not bring any additional benefit.

The imposition of a mandatory cooling off period may encourage moral hazard – i.e. encouraging rash actions (with the false comfort of a "free" – see paragraph (b) below – cooling-off period), and allowing investors to disclaim liability for reading the necessary documents and doing homework where necessary.

The rationale behind the proposed cooling off period – i.e. "...to mitigate any high-pressure sales tactics and to give customers time to reflect on the risks and wisdom of their investment..."[21] – is already dealt with in the existing rules and guidelines of the SFC. In particular, in the last paragraph of part 5 of its "Questions and answers on suitability obligations of licensed and regulated persons who are engaged in financial planning and wealth management business activities ("FAQ")", the SFC states:

> "Each client should be given sufficient time to digest, consider and evaluate the information and recommendations provided by an IA and be given sufficient opportunity to raise queries with the IA. Under no circumstances should IAs use high-pressure or unfair techniques to force or entice any client to make hasty investment decisions."

(b) ***A mandatory cooling-off period would impose additional costs on investors***

If investors have the right unilaterally to cancel the purchase contract after, for example, two weeks, the purchase price for most structured products can be expected to include an amount to account for the additional cost to the distributor or product provider of such cancellation right. In effect, the distributor or product provider will be required to sell the investor a short-dated put option which the investor may not need, or which the investor may consider to be unduly expensive. The additional cost of this embedded "put option" may render the product unviable for the product provider/distributor, or unattractive to the investor.

Alternatively, if the product is not "priced" until the end of the cooling-off period, investors will face uncertainty on the price of their investment during the interim, and (i) will lose out on any rise in value during the interim, and (ii) any fall in value or change in sentiment may cause investors to cancel regardless of the underlying merits. In either circumstance, the investor is ultimately worse off than in the absence of such cooling-off period.

Product providers and intermediaries should also be protected for any dealings they may have in the underlying markets during the cooling off period.

(c) ***A mandatory cooling-off period would not address the issue of mis-selling***

Given that the rationale for a cooling-off period is (as discussed above) to mitigate the risk

[21] Paragraph 8.35, page 76 of the HKMA Report.

of high pressure sales tactics by intermediaries, we strongly urge that the appropriate means to deal with such concern is to focus on the regulation of the activities of intermediaries by way of the Code of Conduct and suitability requirements as opposed to indirectly imposing additional costs within products or onto the product providers.

(d) ***The imposition of a mandatory cooling-off period in relation to the sale of structured products and other securities would be out of step with other major jurisdictions and could therefore adversely affect Hong Kong as an international financial centre and reduce the universe of structured products otherwise available to Hong Kong-based investors.***

As detailed in the Reports[22], while not uncommon in regard to the sale of insurance products and, in certain jurisdictions, unit trusts and other collective investment schemes, we are not aware of a mandatory cooling off period requirement in any comparable jurisdiction in regard to structured products in securities form.

In jurisdictions that do provide for a mandatory cooling-off period, this only applies in limited circumstances. For example, the cooling-off period in Article 16 of the EU's Prospectus Directive only applies after the publication of any supplement to the prospectus. Further issues in the context of a "retail cascade" are discussed in paragraph (e) below.

Accordingly, and in light of the additional costs that such requirement would impose as described in paragraph (b), in our view the introduction of a mandatory cooling-off period would have a negative impact on the market for structured products in Hong Kong.

(e) ***It is not clear on what basis and at which step in the sales chain a mandatory cooling off period should apply in the context of a "retail cascade".***

The proposed cooling-off presumably applies only to "primary market" issuances of structured products (i.e. sales by the product providers directly to retail investors). However, there might be cases where there is a chain of intermediaries:

> Product provider → Initial subscriber → Distributor bank → Asset manager/Broker → Retail investor

The relationship between the entities in the web of intermediaries may well be more interwoven than in this example. In another situation, a broker may purchase a structured product from another investor (secondary market trading) for re-sale to a retail investor. These present difficult issues regarding on what basis and at which step in the sales chain a mandatory cooling-off period should be applied.

(f) ***If, notwithstanding the above, a cooling-off period is to be introduced, there should be an explicit adjustment made for the product provider's "break costs" in addition to an "equitable adjustment" to reflect changes in the market value of the underlying assets.***

The SFC Report[23] states that:

> "... Provision should be made for equitable adjustments to reflect changes in the market value of the assets associated with the investments but not reflect selling or other costs associated with the cancellation."

In our view, the amount returned to the investor during the cooling-off period should also take into account the product provider's "break costs" (i.e. changes in funding costs during the period in which funding is committed in addition to unwind costs for the derivative

[22] See paragraph 32, page 64 of the SFC Report and paragraphs 8.35 to 8.39 at pages 76 to 77 of the HKMA Report.

[23] At paragraph 32.6, page 64.

element) as this would otherwise be a loss suffered by the product provider. If the cost of the investor's right to cancel during the cooling-off period is borne by the product provider, this will result in an increase in the cost of the product for other investors.

(III). A proposal for mandatory disclosure of all commissions received by intermediaries. (*4.5.1, 31.5 and 31.6 SFC Report, 8.10 and 8.14 HKMA Report)*

The SFC Report provides that:

> "31.5 ... The SFC therefore intends to consult the public on a proposal to require Intermediaries to disclose in plain language the following to prospective clients at the pre-sale stage:
>
> 31.5.1 Monetary benefits
>
> (a) The existence and nature of any commission arrangement.
>
> 31.5.2 Trail commission
>
> (a) The existence and nature of any trail commission arrangements.
>
> 31.5.3 Volume discount/Volume benefit
>
> (a) The existence and nature of any arrangements whereby the Intermediaries receive volume discounts/volume benefits in a range of products.
>
> 31.5.4 Affiliation with product issuers
>
> (a) the relationship between the Intermediary and the product issuer;
>
> (b) where applicable, the fact that the Intermediary only distributes the investment products issued by its affiliated group;
>
> (c) where there is no clear commission rebate arrangement, the fact that there is some form of reward or benefit, received either directly or indirectly, from the affiliated product issuer.
>
> 31.5.5 Non-monetary benefits
>
> (a) The existence and nature of any arrangements hereby the Intermediary receives non-monetary benefits including soft dollars.
>
> 31.6 We recommend that the SFC reviews requirements for comprehensive disclosure to clients at the pre-sale stage of commissions, fees and other benefits the Intermediary receives from the sale of the products that it recommends or is offering to clients."

We recognise the importance of ensuring that investors are made aware at the time of sale of the relevant product of the existence of commission received by the intermediary in relation to such sale. This is reflected in Principle 3 of the JAC Principles for Managing the Distributor-Individual Investor Relationship:

"**Principle 3: Fees and Costs**

> Investors in a structured product should be informed of the existence of fees, costs, commissions, discounts, and any other sums paid to the distributor for acting as such over the life of that product.
>
> Distributors should have internal processes and controls in place to consider the appropriateness of fees and other incentives given local market conditions and regulatory requirements.
>
> A distributor's internal processes and controls should also consider the level of disclosure regarding such fees and costs in light of their possible impact on the secondary market of the structured product concerned (insofar as a secondary market exists for the product)."

As discussed at paragraph 31 of its Report, the SFC is concerned that the payment of commission to a "Regulated Person" could lead to a potential conflict of interest on the part of such Regulated Person and therefore investors should be made aware of such payment at the time of sale. We understand this concern, and therefore agree with the proposal that an investor should be informed of the existence of a commission payable to a Regulated Person in relation to any products sold by such Regulated Person to such investor.

However, member firms have reservations about any additional disclosure requirements beyond the existence of a commission. For example, our members strongly agree with the comments in paragraph 31.3 of the SFC Report on the difficulty and impracticality of quantifying commission amounts in a disclosure document. For example, it can be very difficult for a distributor to know the exact quantum of the commission at the pre-sale stage as this is often linked to the amount of securities actually sold during the placement. The amount of commission may also be a variable amount using a complicated formula dependant on multiple factors.

We urge the SFC and the HKMA to consult extensively with the industry on these proposals prior to codifying any new rules.

(IV). A proposal for product providers to provide investors (through intermediaries) with:

(a) on-going secondary market price information; and

(b) notification of changes in circumstances that may have a significant effect on the value of the product. (*27.3 SFC Report*).

The SFC Report provides that:[24]

> "We recommend that requirements are introduced in the SFO for:
>
> 27.3.1 issuers of investment products to provide relevant information for investors including:
>
> (a) price information; and
>
> (b) changes in circumstances that may have a significant effect on the value of the investment; and
>
> 27.3.2 Intermediaries to take appropriate steps to ensure that this information is brought to attention of investors."

We will divide our comments on the above proposals into two parts:

[24] Paragraph 27.3, page 56 of the SFC Report.

(i) the recommendation by the SFC as to the provision of post-purchase on-going price information (SFC Report 27.3.1(a)); and

(ii) the recommendation by the SFC as to ongoing notification of changes in circumstances that may affect the value of the investment (SFC Report 27.3.1(b)).

(i) Post-purchase on-going price information (27.3.1(a) SFC Report)

We broadly support the provision of secondary pricing information in relation to structured products.

Generally speaking, we understand the importance of providing investors with regular performance information in relation to the structured products which they hold. In this regard, the following principles extracted from the Principles for Managing the Distributor-Individual Investor Relationship are pertinent:

> "**Principle 7: Liquidity / Secondary Market**
>
> Investors should be informed before investing of the likelihood of their being able to sell a particular structured product prior to maturity, and of the ways in which this might be done.
>
> Any secondary market to be provided by the distributor itself or through an exchange or otherwise, should be disclosed. If there is little likelihood of such sale or other liquidation being possible, that fact should be clearly disclosed.
>
> Investors should be made aware that sales in the secondary markets, even where possible, may be at prices that are below the amount payable on the product at maturity, the original offering price, or the price at which they acquired the product.
>
> In addition, distributors should make a clear distinction between an investment in the structured product and a direct investment in the underlying asset, and that the return on the structured product may not reflect the return of a direct investment in the underlying asset, noting in particular that these respective returns may not necessarily move in tandem.
>
> For principal-protected products, it should be made clear to investors that the principal protection applies only at maturity, and the costs of unwinding the product mean that an earlier redemption value may differ materially from the potential value at maturity."
>
> "**Principle 7a. Client Valuations**
>
> Structured products should be valued on a regular basis and disclosed to the investor through the distributor's normal client statement process or otherwise."
>
> "**Principle 12. Post-Trade Follow-up / Product Life Cycle Issues**
>
> Distributors should provide financial advisors with the necessary information to help their clients monitor performance of any structured product in which they have invested, and provide access to information regarding the terms of that structured product, including its maturity, pay-out details, secondary market price (insofar as a secondary market exists for the product), and other pertinent information."

We recognise that many product providers in relation to certain structured products do currently provide pricing information, which information may be distributed to the market via the relevant intermediaries. However, this is true only in the case of a narrow sub-set of structured products. Any such requirement to provide pricing information should not apply in respect of offerings which are exempt from the authorisation requirements under the Securities and Futures Ordinance and the prospectus regime in the Companies Ordinance. Further, we would suggest that provision of such pricing information would be difficult for fund-linked products when the net asset value of the underlying funds may not be readily available, and when there is generally considerable delay between a fund's valuation date and its publication date. Accordingly, given the time gap between valuation dates and publication dates may render indicative valuations for fund-linked products potentially misleading, we suggest that the requirement to provide periodic indicative valuation for products fund-linked products should only be provided on a best endeavours basis.

Further, it is vital to make a distinction between providing regular valuations of a product on the one hand and actively providing a secondary market for the product on the other. For example, many structured products are designed by the relevant product provider to be hold-to-maturity investments. A key funding assumption made by product providers in relation to such products is that the investor will hold the product until it matures. If the product provider is obliged to make a secondary market for such products, such funding assumption will be revised upwards to factor in the additional costs of such potential early redemption amount, and the purchase price of the product will likely increase or the product may not be offered at all. Investors should be informed at the time of sale that a particular product is a hold-to-maturity investment in which pricing information shall not be provided and a secondary market is unlikely to develop. According to JAC Principle 7: "[a]ny secondary market to be provided by the distributor itself or through an exchange or otherwise, should be disclosed. If there is little likelihood of such sale or other liquidation being possible, that fact should be clearly disclosed". There is also a concern that where pricing information is provided without an obligation to repurchase or without a functioning secondary market, such pricing information may create a false sense of security with investors that such products may be sold at such price.

Finally, the pricing information that is currently being provided in the market differs both in terms of frequency of publication and the method of publication. It may be difficult to provide updated information for some products as frequently as others, depending on the underlying asset, risk or structure. During extreme market conditions, pricing information may also not be available within a short timeframe. We would very much appreciate the opportunity to work together with the SFC to develop workable guidelines around such details as well as the scope of any such requirement.

(ii) Post-purchase reporting of "changes in circumstances that may have a significant effect on the value of the investment" (27.3.1(b) SFC Report)

We very strongly urge against the introduction of a requirement to report "changes in circumstances that may have a significant effect on the value of the investment". Our reasons are as follows:

(a) ***The phrase "changes in circumstances that may have a significant effect on the value of the investment" is extremely broad and could cover a multitude of events.***

For example, economic or political events, events specific to the issuer, the guarantor or a counterparty or events which may impact on the underlying reference asset may all affect the value of a structured product investment. We note as well that, in the event that a requirement is introduced to provide pricing information (as discussed in (i) above), this would effectively serve the same purpose as any requirement to disclose circumstances that may affect the value of an investment;

(b) The value at any one time inherent in an investment product – particularly a structured product – may be affected by a diverse array of factors. Therefore:

(i) it will often not be clear whether and to what extent any particular event affects the value of a product, and product providers may well have different opinions of the same events and consequently there may not be a uniform level of disclosure by product providers in the market;

(ii) it may not be possible to determine whether an event has a significant effect on the value of the structured product until some time after the event has occurred. Also, in view of the logistics of sending notices (e.g. translation requirements so that the notice is in both English and Chinese and the potential for delay as a notice works its way through a distribution network), it may take some time for the notice to ultimately reach the end investor. For these reasons, it would be difficult to provide timely notice of such event; and

(iii) there may be a significant additional cost involved in monitoring all potential material developments and making such determinations, which cost would indirectly be borne by investors;

(c) Product providers will be concerned with potential liability for failure to identify (and communicate) "circumstances" which in retrospect cause a "significant" fall in the value of the structured product. This concern could also lead to a deluge of warnings which may not ultimately be useful to investors;

(d) There is a significant possibility that a requirement to provide such information may stifle the variety of structured products available, with only the simplest structured products being offered because more complex products (or products referencing a diversified basket of reference assets) may have much greater reporting obligations disproportionate to the overall risk;

(e) We are not aware of similar requirements currently being imposed in other major comparable jurisdictions on retail structured products, and currently no international consensus has been reached on the need for such a requirement.[25] Accordingly, there could be adverse consequences to the Hong Kong market of any such notification obligations; and

(f) Product providers will receive, in the course of their business, confidential and market-sensitive information through their banking and investment banking activities. An open-ended obligation to notify investors of events which have a significant effect on the value of the product may well conflict with the obligation to keep market-sensitive information confidential.

For these reasons, we are very strongly opposed to this proposal.

(V) A requirement for registered institutions to continuously monitor the "risk rating" of products they have sold and inform existing customers if the risk ratings rise. (*8.32 HKMA Report*)

The HKMA Report states that:[26]

> "[w]here the continuous review by a registered institution of the risk ratings of the investment products it sells results in a higher risk rating being attributed to the product, the institution should disclose this to customers to whom it recommended and sold the product."

We, as an industry, acknowledge the importance of providing investors with certain information post-trade, and during the whole product life-cycle, as set forth in JAC Principle 12 (as also set out above):

"**Principle 12. Post-Trade Follow-up / Product Life Cycle Issues**

[25] We note that there is currently an ongoing enquiry in the EU of much more limited scope with regard to product transparency. For example, the Committee of European Securities Regulators (CESR) is currently conducting a consultation on the extension of MiFID post-trade transparency requirements to Asset-Backed Securities (ABS), Collateralised Debt Obligations (CDO), Asset-backed Commercial Paper (ABCP) and Credit Default Swaps (CDS), which have predominately been sold to institutional investors.

[26] Paragraph 8.32, page 75.

Distributors should provide financial advisors with the necessary information to help their clients monitor performance of any structured product in which they have invested, and provide access to information regarding the terms of that structured product, including its maturity, pay-out details, secondary market price (insofar as a secondary market exists for the product), and other pertinent information."

We are generally supportive of this recommendation. Our main concern with this recommendation is that without an agreed methodology to allocate such ratings, there will be a lack of consistency amongst institutions even with regard to very similar products both as to (1) the initial allocation of a "risk rating" and (2) whether, when and by how much such rating should be changed following various events. Further, we would like to point out that risk ratings of structured products should not be overemphasized to investors. Risk is multi-dimensional and there are many types of risks inherent in a structured product. A single risk rating may not be the best indicator to capture all types of risks present in the product. Accordingly, investors should be encouraged to understand the benefits, risks and liabilities inherent in the product before making any investment decisions rather than solely relying on the risk rating of the product..

We are not aware of any jurisdiction which has mandated publication of changes in "risk ratings." However, there has been some work done by industry groups around standardisation of product ratings (e.g. in Germany). We wish to support the HKMA in this undertaking, with the proviso that we would like to be consulted on proposed risk rating criteria to assist the HKMA in devising appropriate terms and methodology in relation to structured products.

(VI). A proposal that the SFC bring forward requirements for intermediaries to adopt suitable criteria for characterising investors with a view to assisting in ensuring that investment advice and products offered are suitable for the investors. (34.3 SFC Report)

We recognise the fundamental importance of the suitability determination with regard to the marketing of structured products. We would be pleased to assist the HKMA and SFC in the development of appropriate "Best Practices" standards for establishing criteria in relation to assessing the risk profile of retail investors.

We note that intermediaries are already obliged to consider the particular risk position of retail clients pursuant to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, at Sections 5.1, 5.2 and 5.3. We would wish to ensure that, in requiring intermediaries to develop suitable criteria for risk categorisation of investors, the "human element" and active decision-making in assessing suitability vis-vis particular investors is not lost and subsumed into a "mechanical" box-ticking exercise using inflexible criteria.

(VII). A proposal that an Ombudsman service (or equivalent) be created with a view to the establishment of swift and cost-effective measures to resolve disputes. (35.5 SFC Report and 8.49 HKMA Report)

We broadly support this proposal, given the potential for a quick, simple and effective dispute resolution process. Retail investors will benefit from a cost-effective way to bring complaints on mis-selling, and the industry will benefit from a boost to investor confidence. We urge careful consideration of such services in comparable jurisdictions, such as the scheme in the United Kingdom, in the context of Hong Kong's situation. The details of any such scheme will be crucial to its success.

Conclusion

We fully support the initiatives of the Hong Kong authorities to review and, where necessary, reinforce the existing "two pillars" regulatory regime for the sale of structured products to retail investors. We are grateful for the opportunity to present our views on the Reports, and we are committed to working with the government and regulators in this endeavour to help to re-build confidence in the structured products market in Hong Kong.

Appendix 1

Joint Associations Committee (JAC)

Structured Products: Principles for Managing the Distributor-Individual Investor Relationship[27]

The distributor-individual investor relationship should deliver fair treatment of the individual investor. Individual investors need to take responsibility for their investment goals and to stay informed about the risks and rewards of their investments. Distributors can play a key role in helping them achieve these objectives. In this document, an "investor" means a retail investor who is not an institution, a professional, or a sophisticated investor, and a "distributor" refers to any institution or entity that markets or sells retail structured products directly to an individual investor. This will include an issuer of a retail structured product that markets or sells the same directly to individual investors.

In light of the increased interest in structured products as part of individual investors' investment and asset allocation strategies, it is important for firms to keep these principles in mind in their dealings with individual investors in structured products. These principles complement and should be read in conjunction with our recently released, "Retail Structured Products: Principles for Managing the Provider-Distributor Relationship," available at the websites of the five sponsoring associations[28], which focus on the relationship between manufacturers and distributors. These principles apply to the relationship between the distributor and the individual investor.

Although these principles are non-binding (being intended primarily to help inform firms' thinking) and do not create enforceable obligations or duties, firms involved in the distribution of structured products to individual investors are encouraged to reflect these principles in their policies and procedures. Further, each firm is encouraged, given differing regulatory environments and both cultural and client base differences, to consider the extent to which the firm should adapt these principles to its particular circumstances. As stated in the related Provider-Distributor Relationship Principles noted above (Principle 7), "no party takes on the regulatory obligations of another or the oversight of that other party's compliance with those obligations.".

For the avoidance of doubt, these principles are intended primarily to apply in the context where structured products are actively marketed and/or recommended by distributors to individual investors, and not where distributors are merely executing transactions for investors on a non-advised, non-discretionary basis. Where distributors are executing on this basis, those parts of these principles that are not appropriate to such relationships (for example, those relating to secondary market making and client appropriateness and suitability) shall not apply.

Overview

The term "structured products" refers to a variety of financial instruments that combine various cash assets and/or derivatives to provide a particular risk/reward profile that allows investors access to broader investment opportunities. The return of a structured product is usually derived from the performance of one or more underlying assets. Examples of underlying assets include, but are not limited to: interest rates; a particular equity or debt instrument; a basket of securities; a securities index or indices; an individual commodity or commodities; a commodities index; an individual currency or currency basket; creditworthiness of a security or basket of securities; or any combination thereof.

Some structured products offer full or partial principal protection, while others have no principal protection. Some offer a yield; others do not. It is possible that the value of an individual structured product may not increase as much as the underlying asset, or may decrease more than

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27 Published in July 2008

28 European Securitisation Forum, International Capital Market Association, International Swaps and Derivatives Association, London Investment Banking Association, Securities Industry and Financial Markets Association

the underlying asset. Some structured products offer individual investors access to new asset classes that may otherwise be difficult to access through other investment alternatives and which can help with portfolio diversification.

Structured products can be more or less risky than other investment products such as equities, fixed income products, or mutual funds: there is no necessary link between product complexity and investment risk - complex products may be low risk, and non-complex products may entail high risk. It is important that an investor understands the role in an investment strategy that can be played by any particular structured product in light of the investor's specific investment objectives, risk tolerance, and investment horizons.

Principles

These Principles should be read in conjunction with the Overview and Introduction section set out above, which contains important overarching comments to the nature and scope of the Principles. Moreover, the Principles are to be taken collectively, rather than viewing any one Principle in isolation from the others.

1. Product Transparency

The party who is primarily responsible for the creation of marketing materials,[29] or is responsible for a prospectus, or other offering memorandum, should, to the extent permitted by applicable laws and regulations[30], use reasonable efforts to ensure that the material features of the particular structured product are clearly articulated and delineated in such marketing materials or prospectus in a way that enables individual investors to evaluate the investment from a risk/reward perspective. Such party should also ensure that structured product descriptions in client materials and prospectuses are clear and not misleading. This will be helpful to both individual investors' and financial advisors'[31] understanding of the product. Further, to the extent that a distributor is primarily responsible for the creation of marketing materials, such materials should be adapted to, and reflective of, the knowledge and sophistication of individual investors in the target market. For example, it should be clearly disclosed how returns on a structured product are linked to an underlying asset.

Marketing materials that are distributed to, or intended for distribution to, individual investors should be subject to review by the distributor's appropriate supervisory staff, as well as other internal processes, such as compliance or legal, as appropriate.

2. Risk Disclosure

Risk disclosure is important to an investor's understanding of structured products and should be made available to investors before a decision to invest is made. Investors should understand the risks inherent in the product before investing in it. Investors should be informed of the general types of risks associated with structured products, subject to individual regulatory standards as to the specific language required. Particular prominence should be given to any risk not usually associated with a given product, for example, risk of loss due to any sale of the product before maturity, as well as any material product-specific risk that may apply, such as risks arising from the underlying asset, liquidity and market risks in relation to the product itself, or specific tax considerations. Where information on past performance is given, the presentation should be fair and not misleading, and, in particular, should acknowledge any limitations in available data.

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29 The relationship between providers and distributors is specifically addressed in "Retail Structured Products: Principles for Managing the Provider-Distributor Relationship," Principle 5, Joint Trade Associations, July 2007.

30 In some jurisdictions, law and regulation may specify or limit the form, the content or the presentation of material which may be given to investors. These principles do not require such rules to be disregarded.

31 "Financial advisor" refers to the firm's employees, or independent contractors, who interact directly with individual investors and who are registered to solicit trades and effect transactions. The formal term may vary significantly by firm and/or jurisdiction.

3. Fees and Costs

Investors in a structured product should be informed of the existence of fees, costs, commissions, discounts, and any other sums paid to the distributor for acting as such over the life of that product. Distributors should have internal processes and controls in place to consider the appropriateness of fees and other incentives given local market conditions and regulatory requirements. A distributor's internal processes and controls should also consider the level of disclosure regarding such fees and costs in light of their possible impact on the secondary market of the structured product concerned.[32]

4. Potential Conflicts Management

Distributors should have internal processes and controls in place to consider potential conflicts issues and identify measures designed to mitigate, manage, or disclose material conflicts of interest arising from the sale of structured products. Such processes should, where necessary or appropriate, provide timely, adequate, and clear disclosure related to conflicts of interest or potential conflicts of interest that may exist or arise in connection with the distributor's sale of the structured product, or as a result of the business they conduct.

5. Credit Ratings

Credit ratings of issuers or, where applicable, guarantors, may not represent a rating of the potential investment performance of the individual structured product itself. Credit ratings, however, should be taken into account to the extent that it affects the terms of the product. If credit ratings are provided, the related disclosure should make clear the significance of the rating. Distributors should use credit ratings accordingly.

6. New Product Review

Distributors should understand the products they distribute. New structured products, whether developed by the distributor or developed by a third-party provider or manufacturer, should be subject to the distributor's product review and assessment process. This process should take into account the nature of the new structured product, the target investors, and an assessment as to whether the product is appropriate for its intended target market. Distributors should also have a process for determining what generally constitutes a "new product." It is not sufficient for a distributor to accept a third-party manufacturer's assessment regarding appropriateness of structured products for individual investors who are ultimately customers of the distributor and not the manufacturer. Distributing firms should conduct an independent assessment.

7. Liquidity/Secondary Market

Investors should be informed before investing of the likelihood of their being able to sell a particular structured product prior to maturity, and of the ways in which this might be done. Any secondary market to be provided by the distributor itself or through an exchange, or otherwise, should be disclosed. If there is little likelihood of such sale or other liquidation being possible, that fact should be clearly disclosed. Investors should be made aware that sales in the secondary markets, even where possible, may be at prices that are below the amount payable on the product at maturity, the original offering price, or the price at which they acquired the product. In addition, distributors should make a clear distinction between an investment in the structured product and a direct investment in the underlying asset, and that the return on the structured product may not reflect the return of a direct investment in the underlying asset, noting in particular that these respective returns may not necessarily move in tandem. For principal-protected products, it should be made clear to investors that the principal protection applies only at maturity, and the costs of unwinding the product mean that an earlier redemption value may differ materially from the potential value at maturity.

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32 Insofar as a secondary market exists for the product. See Principle 7.

7a. Client Valuations

Structured products should be valued on a regular basis and disclosed to the investor through the distributor's normal client statement process or otherwise.

8. Client Appropriateness and Suitability

Where a firm actively markets a particular product, as opposed to merely executing transactions on clients' instructions, it should determine which particular types of clients the product could properly be sold to (appropriateness) and may also be required to determine whether the particular product is right for a particular client (suitability). Methodologies and standards for making these determinations should be developed by the distributor and adequately communicated to the distributor's financial advisors. Liquid net worth, degree of sophistication, risk profile, age, and investment experience are several variables that may be relevant to such an assessment. Also, financial advisors should consider how a specific structured product would fit into an individual's portfolio. These standards should be reviewed periodically and amended, as needed.

9. Financial Advisor and Supervisor Training

Structured products vary a great deal as to their terms, risk/reward profile, liquidity/availability of a secondary market, underlying asset, and a variety of other factors. As such, it is important that financial advisors interacting with individual investors have an adequate understanding of structured products in general as well as an understanding of the characteristics of the individual structured products being offered. The financial advisor should be able to clearly explain the product's features to an individual investor. Distributors should provide their financial advisors with the necessary training, or access to training, in structured products, including both the benefits and risks of the products, and should consider providing educational materials on structured products generally, in a suitable form (including one-on-one meetings, written materials, class-based training, desktop training, or other forms, as appropriate). Such training should also be provided to those responsible for supervising financial advisors.

10. Oversight and Compliance

Structured product sales to individual investors should be subject to the distributor's internal legal, compliance, and supervisory review processes, policies, and procedures. Distributors should have such supervisory procedures in place covering transactions in structured products, which should involve supervisory staff of appropriate seniority in light of the nature of the particular product and investor target market. Supervisory responsibilities may encompass sales practices, reasonableness of profit/loss potential, fees, and adequacy of training. Managers performing such supervision should have access to appropriate legal and compliance department support.

11. Tax Implications

Investments in structured products may have tax consequences for individual investors depending on their personal circumstances and jurisdiction of residence. Although certain tax implications may be highlighted in product documents, investors should be encouraged to discuss the specific tax implications of structured products with their accountant, tax attorney, or other tax professional.

12. Post-Trade Follow-up/Product Life Cycle Issues

Distributors should provide financial advisors with the necessary information to help their clients monitor performance of any structured product in which they have invested, and provide access to information regarding the terms of that structured product, including its maturity, pay-out details, secondary market price,[33] and other pertinent information.

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[33] Insofar as a secondary market exists for the product. See Principle 7.

Appendix 2

Joint Associations Committee (JAC)

Retail Structured Products: Principles for Managing the Provider-Distributor Relationship[34]

A. Introduction

These Principles seek to address issues that financial services firms have in practice found helpful to consider when performing the function of either provider or distributor in connection with the process of delivering structured products to retail investors.

It should be noted that **the Principles are non-binding and, as such, intended purely to help inform firms' thinking**. The sponsoring associations believe market participants should be free to agree their relationships and relative responsibilities on a case-by-case basis, to the extent these are not prescribed by local law or regulation. The Principles are intended to be sufficiently broad in their applicability to provide a reference framework for managing the provider-distributor relationship in retail structured products markets globally.

The Principles are the product of a global working group of firms, taking in the views of both distributors and providers and supported by a coalition of trade associations: European Securitisation Forum (ESF), International Capital Market Association (ICMA), International Swaps and Derivatives Association (ISDA), London Investment Banking Association (LIBA) and Securities Industry and Financial Markets Association (SIFMA). Furthermore, the associations issued the Principles for public comment, obtaining constructive feedback from other trade associations and market participants.

Structured products include a variety of financial instruments that combine various cash assets and/or derivatives to provide a particular risk-reward profile that would not otherwise be available in the market. The exact risk-reward profile varies from instrument to instrument.

The arrangements between the parties, the applicable regulatory regime and the fact that structured products combine various components may in practice result in different financial services parties being responsible for different aspects of the related regulatory obligations (even though the universal-bank model may entail a 'proprietary product distribution' arrangement). In particular, it is common for the distributor to have a direct interface with the retail investor while the provider does not. These Principles therefore particularly focus on how to address this issue, wherever it arises, given that all parties within this distribution 'chain' have a common interest in ensuring that investors obtain satisfaction with regards to their legitimate expectations as to the nature of the investment.

Retail investors in this context will mean natural persons and may include high-net-worth individuals. The Principles do not, unless otherwise indicated, address the role of entities acting solely as issuer of a product.

The Principles are drafted with no single jurisdiction in mind; they are, on the contrary, intended for global use, at a high level. The specific and possibly more detailed procedures that any firm might in practice (and subject to appropriate cost-benefit analysis) adopt to help it manage provider-distributor relationships with regards to retail structured products will be a function of factors such as the jurisdiction or jurisdictions involved, the distribution channel(s) utilised, the precise nature of the products and the nature of the relationship between the parties.

Regulatory treatment may depend on the nature of the component instruments; for instance, depending on the jurisdiction, structured deposits or exchange-traded notes acquired by investors via brokers on a 'reverse-enquiry' basis may each require separate analysis. Among other

[34] Published in July 2007

matters, due consideration will need to be given to post-sale arrangements such as secondary market-making activity and information provision. The sponsoring associations invite industry to consider adapting the Principles, as appropriate, to take account of such specific factors.

B. Principles

These Principles should be read in conjunction with the Introduction above, which contains important overarching comments on the nature and scope of the Principles. Moreover, the Principles are to be taken collectively, rather than viewing any one Principle in isolation from the others.

1. Distribution to the retail investor in structured products in many, though not all markets, is effected through intermediaries, e.g. private banks, rather than directly by the product 'provider' (sometimes referred to as 'manufacturer').

2. Where a product provider and a private bank (or other retail-facing business) operate within the same institution, they may operate quite distinctly; they may even be subject to different regulation; or have different reporting and management structures. Any such formal separation is generally robust and will be driven by legal, compliance, confidentiality and other requirements. Thus, even where a product is originated and distributed by the same institution, there can, in practice, be a separation between the manufacturing and distribution functions to which these Principles refer.

3. Product providers should consider what internal approval processes are appropriate for retail structured products; any such processes might address such issues as sign-off, product structuring, risk-reward and distribution.

4. The distribution structure means that it is often the distributor who interfaces with the individual investor and whose client that investor is. In such circumstances, investor suitability (as determined in the local market) is accordingly exclusively an issue for distributors, since it must be considered in the context of confidential information provided by the client to the distributor.

5. Distributors must understand the products they distribute. In jurisdictions where distributors provide not only the issuer's prospectus document but also term-sheets or other marketing material (such as brochures) to their clients, the distributors take responsibility for the accuracy and completeness of those marketing materials, even if they incorporate material provided by the product provider; in these circumstances, a distributor must be satisfied with and take responsibility for such materials and their compliance with local law and regulation.

6. Product providers should ensure that their term-sheets are accurate, fair, balanced and clear (respecting, as appropriate, jurisdiction-specific regulation to this effect); and that they are presented in a way which is consistent with their agreed obligations to the distributor. (For example, where the parties understand that the product will be distributed by the distributor to high net worth individuals, the termsheet should not contain rubric that the product is not suitable for retail investors.) Where providers agree to assist the distributor by supplying information, this should be clear and of the kind requested by the distributor in preparing its own term-sheet or product description for its client; this may include scenario analyses and relevant-to-product risk factors.

7. When commencing dealings with a distributor, product providers should consider whether the distributor is an appropriate distributor for the placing of particular types of products and, where they consider it necessary, practical and appropriate to do so, should conduct a "know your distributor" approval process. There is no fixed form for this process, which can vary according to the circumstances, and there are a number of means by which a provider can gain comfort as to the integrity of a distributor's processes. Issues which may typically be considered include a distributor's typical client type (and whether the

distributor deals directly with them or via sub-distributors), suitability determination processes, regulatory status, reputation and compliance with selling laws; though the specific details considered will vary widely depending on the distribution, the particular product and the relevant jurisdiction or jurisdictions. Each party does, in any case, retain its own regulatory obligations; no party takes on the regulatory obligations of another or the oversight of that other party's compliance with those obligations.

8. Distributors should also evaluate product provider counterparties ("know your product provider"), particularly as regards the product provider's performance with respect to those items mentioned in 6 above.

9. To the extent that law and regulation may not distinguish sufficiently between the roles of product providers and distributors, this may create points of uncertainty as to where legal or regulatory liabilities may fall. Providers and distributors should be aware of this and its consequences.

10. Product providers and distributors should seek to agree and record their respective roles and responsibilities towards investors.

Appendix 3

The International Swaps and Derivatives Association (**ISDA**) has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective, both in terms of the depth of presentation across the derivatives industry and in terms of international representation and understanding of the regulatory arrangements in other jurisdictions.

The Securities Industry and Financial Markets Association (**SIFMA**) brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.