

## Principles

### Outcomes the Principles should help to support

- The purchaser 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 investment recommendations should expect the provider to take reasonable care in the provision of that investment advice.

## Principles

### 1. Principles applying in all stages of the distribution process

#### 1.1 Relevant financial instruments

***Consideration a. The Principles should apply to all forms of securities, collective investment schemes and related derivatives instruments referred to in these Principles as “investments”.***

**Discussion:** The Associations have limited their focus to instruments that are covered under the scope of IOSCO’s remit rather than to all investment products (e.g. insurance products). This is not to ignore the wider international discussion on the distribution standards for other categories of product (and within the EU in the context of the Packaged Retail Investment Product (PRIIPs) consultation) but we felt that attempting to address it here would go beyond SC3’s mandate and requires further consideration. The Associations also do not believe that IOSCO should define its analysis of suitability issues around a category of complex products. Complexity does not always mean additional risk and conversely, some supposedly non-complex products can be very risky. We believe that a more effective approach would be to look at all products and types of securities investments and the balance of risk and reward associated with them.

#### 1.2 Customers and firms

***Consideration b. The Principles should apply whenever a firm deals or provides services in relation to investments with or for a person on whose behalf it is acting (referred to in these Principles as a “customer”). In these Principles, a firm acting in that capacity is referred to as an “intermediary”. Where a firm is responsible for structuring and issuing or arranging for the issue of an investment, it is referred to in these Principles as a “product producer”.***

**Discussion:** There is recognition that there are different classifications and categorizations around the definition of customers/clients/counterparties, etc across the world. For the sake of simplicity, we have used the expression “customer” in these principles to cover those persons on whose behalf the firm is acting (while recognising that a firm may have relationships with counterparties who will not be customers because the firm will be dealing with them at arm's length, for example in a dealer-to-dealer relationship). There is also recognition that a single firm may act only as a distributor of financial products, or only as a

product producer, or in both capacities. We have attempted to address these differing capacities in the Principles.

***Consideration c. The Principles should be applied in a way that recognizes the relative sophistication, capability and ability to bear investment loss of the customer concerned.***

***Consideration d. In applying the Principles, 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.***

*Means for Implementation:*

*An intermediary should assume that natural persons have the least sophistication, capability and ability to bear investment loss and large institutions the most. However, this is only a starting point so that, for example, high net worth customers with sophistication in the relevant investments or access to additional support, might be treated more like institutions.*

*An intermediary should make clear to its customer at the outset what assessment it has made and the implications of that for how it will treat the customer.*

*Customers should be able to agree a different approach with the intermediary, recognizing: (i) that it may have cost implications; (ii) that the customer may need to provide more information to the intermediary; and (iii) that it may mean that the range of investments available to the customer is more restricted.*

*In line with Considerations b and c, where an intermediary deals with institutional customers as its equals, and they are not relying upon it for the provision of personal investment recommendations or the exercise of discretion on their behalf, the duty of that intermediary towards such customers will necessarily be very limited.*

#### **Discussion:**

(a) The reference above to firms with whom an intermediary deals as its equal is intended to reflect the sort of situation contemplated, for example, in the EU regulatory rules in relation to eligible counterparties and thus to apply to inter-dealer relationships. In such cases, whilst the firm will still owe the counterparty a minimum duty (e.g. around disclosure of conflicts of interest), its duties will be very limited on the basis that the counterparty is in a position to adequately protect its own interests.

(b) A number of regulatory regimes specifically distinguish between retail and institutional customers. In addition, the EU regime, for example, also contemplates that a customer can move up the ladder if certain sophistication criteria are satisfied and that firms and customers can also agree a higher level of protection. We believe that customer categorization is an important part of the overall framework which needs to be acknowledged within the Principles. While we do not believe that the Principles should focus on the details of this

categorization, we do believe that there is a compelling case for developing a non-exhaustive international understanding as to those categories of customers who can always be treated as falling within the “professional/institutional” category, for all purposes and wherever located. In addition, where national regulators make more detailed rules, they should be encouraged to introduce a distinction between retail/institutional customers (with the ability for customers to opt to move between the two), only applying the full regime to the former. In order to assist certainty (and therefore avoid potential costs) the tests for distinguishing between the two need to be as objective as possible (for example, using indicators such as regulatory status and size).

(c) In the Principles below and in line with the approach being taken by IOSCO, reference is made to ‘suitability’ obligations and assessments. It should be understood though that the Principles are consistent in approach and intended effect not only with those jurisdictions that apply or seek to apply a ‘suitability’ requirement but also with those jurisdictions or regulatory authorities that apply a ‘fiduciary’ duty.

### 1.3 Dealings with customers – handling conflicts

**Principle 1.** *An intermediary should ensure that its customers are fairly treated. In doing so, it should try to avoid conflicts of interest that could have a material adverse effect on their customers and, when they cannot reasonably be avoided, mitigate them, including through disclosure to the customer.*

**Principle 2.** *An intermediary should not in relation to any service provided to a customer receive a payment or benefit from any person or provide any payment or benefit to any person other than the customer unless: (i) its receipt will not have a significant adverse effect on the discharge of the intermediary’s duties to the customer (for example, by creating commission bias); and (ii) its nature and amount is clearly disclosed to the customer before the service is provided. Where it cannot be ascertained before provision of the service, the basis upon which any amount will be determined should be disclosed and the market intermediary should provide further details once they are available if the customer requests it.*

**Discussion:** The Associations are aware that there is a wider debate as to the future role of product provider commissions. The underlying principle is that the quality and outcome of a service to a customer should not be undermined by these commissions regardless of the business model being used by the intermediary.

### 1.4 Communications with customers

**Principle 3.** *An intermediary should make adequate disclosure of relevant material information in its dealings with its customers. All communications should be clear, fair and not misleading.*

*Means for Implementation:*

*An intermediary should also respond appropriately to customers’ requests for information, bearing in mind that this may have a cost for the customer.*

*An intermediary should avoid making a communication in relation to investments that could lead customers to believe that the intermediary is*

*making an investment recommendation to them unless that is the intermediary's intention and its intention is made clear in the communication.*

**Discussion:** The Associations believe that this Principle is fundamental and is relevant regardless of the level of sophistication or capability of the investor

## **1.5 Culture and capability**

### **Principle 4. An intermediary should:**

**a) foster a culture in which its staff are likely to act in accordance with these Principles;**

**b) have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.**

*Means for Implementation:*

*An intermediary should take reasonable steps:*

*(a) to put in place (i) training that is appropriate to the role of the staff concerned; and (ii) an independent compliance function. In each case, these should support a culture consistent with these Principles rather than just a "compliance culture"; and*

*(b) to ensure that its management receive sufficient information as to any activities it undertakes of a sort covered by these Principles to enable them to assess whether the intermediary has acted in a manner consistent with the Principles.*

**Discussion:** The Associations recognize that the objective of building the right culture is critical and believe that it deserves greater attention in international standards of good practice than it has hitherto received. It would be possible to draft ever more detailed sets of rules and to require staff to memorize them. However, even with the best rules in the world, if culture is weak, they will provide only limited protection against the "wrong" decisions being made in the heat of the moment, or even in the ordinary course.

### **Principle 5. Firms should take appropriate steps to manage their relationships with other firms in the investment distribution chain.**

*Means for Implementation:*

*Where a firm is one of two or more firms involved in the process whereby an investment exposure is assumed by a customer it should consider the following:*

*(a) Whether the others are appropriate for their role including, where necessary, undertaking due diligence in order to assess whether the standards and processes of another firm in the chain are sufficiently robust.*

*(b) Where law and regulation do not distinguish sufficiently between the roles and duties of those involved, whether this could create legal or regulatory*

*uncertainty and the possible consequences. Where necessary, it should take steps to reduce or eliminate uncertainty, including by defining its relationship contractually or otherwise in writing.*

*Product producers should ensure that materials they produce or for which they are responsible, such as term sheets, which are to be used in the distribution process are fair, balanced and clear (respecting, as appropriate, jurisdiction-specific regulation to this effect) and are presented in a way which is consistent with their agreed obligations to the intermediary. Where product producers agree to provide an intermediary with information to enable the intermediary to create its own customer materials, this should be clear and of the kind requested by the distributor.*

**Discussion:** Three years ago, a number of industry associations (including the ESF, ICMA, ISDA, AFME and SIFMA) – collectively the Joint Associations Committee - developed with their members and have since sponsored two sets of principles designed specifically for firms acting as product producers and distributors in the structured products market: *Retail Structured Products: Principles for managing the provider-distributor relationship*, and *Principles for managing the distributor-client relationship*. Both are available on the ISDA website. A number of the Principles reflect those documents, particularly this Principle 5.

## **2. Principles that are relevant before an investment is recommended or sold**

### **2.1 Pre-service information to customers**

**Principle 6.** *An intermediary should disclose clearly and in sufficient detail for the customer to make an informed decision about whether to proceed:*

*(a) the nature of the services it will provide, particularly whether it is restricted to executing an investment transaction or will include the provision of personal investment recommendations or discretionary investment management services;*

*(b) the nature of the investments covered by the service and whether or not the service will be provided by reference to substantially the whole of the market for investments of that sort; and*

*(c) the basis of its remuneration.*

**Principle 7.** *An intermediary should consider whether it is appropriate to tell customers that do not seek investment advice (including via discretionary management) that it may be in their interests to do so.*

*Means for Implementation:*

*The nature and level of disclosure should be commensurate with the service to be provided. However, where the service involves the provision of personal investment recommendations or discretionary management, the intermediary should make clear whether the service is independent or provided on some other basis. The intermediary should explain how the basis on which the*

*service is provided could affect the recommendations given or decisions taken on behalf of the customer. For intermediaries operating exclusively on an 'execution-only' basis, their clients should understand that they will not receive any investment advice for any transaction.*

## **2.2 Product assessment by market intermediary**

**Principle 8.** *An intermediary that markets investments or provides personal recommendations or discretionary management in relation to investments must understand the features and characteristics of the investments concerned and their risk/reward profile and material risk attributes. In assessing any investment, an intermediary should exercise its own judgment in a manner consistent with responsible professional opinion.*

*Means for Implementation:*

*An intermediary providing personal recommendations or discretionary management will be unable to ascertain the suitability of the investment for a customer's needs unless it performs this assessment. It should not place undue reliance upon statistical modeling tools and should assess any tools used sufficiently to understand their shortcomings.*

*In assessing the suitability (as referred to in Principles 10 and 11) of an investment for a particular use, intermediaries can take into account whether a particular investment is subject to product or transparency regulation since these are relevant to whether it is likely to be suitable for investors of a particular class.*

## **2.3 Understanding the individual customer**

**Principle 9.** *Unless operating on an exclusively execution-only basis and likely to be understood as such, an intermediary should seek from its customers information about their financial situation, investment experience and investment objectives relevant to the services to be provided.*

*Means for Implementation:*

*When entering into a relationship which will involve the provision of personal investment recommendations or the exercise of investment discretion, intermediaries should make reasonable efforts to understand the needs and circumstances of their customer and to obtain information on, for example, the investor's financial situation and needs, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the intermediary considers to be necessary to enable it to advise unless the intermediary can reasonably satisfy itself that the customer is capable of evaluating risks independently, and doing so in practice.*

### 3. Principles applying at the point of transacting

#### 3.1 Suitability of personal investment recommendations or investment management decisions

**Principle 10.** *An intermediary must take reasonable steps to ensure that a personal recommendation or decision in the exercise of investment management discretion to trade on behalf of a customer is suitable for its customer.*

*Means for Implementation:*

*An exchange of trading views between a firm and another participant in the market which can be treated as an equal should not be regarded as a personal recommendation.*

**Principle 11.** *In determining whether a particular investment is suitable under Principle 10, the intermediary should satisfy itself on the basis of the information obtained from the client under Principle 9, that:*

**(a)** *The relevant investment transaction is consistent with the customer's investment objective;*

**(b)** *The relevant investment transaction will not expose the customer to a loss that is greater than the customer is able to bear consistent with the customer's financial situation and the customer's investment objective; and*

**(c)** *The customer has the knowledge and experience to understand the features, characteristics and risks of the particular investment.*

*The intermediary should not make a personal recommendation of an investment transaction to a customer or enter a transaction in the exercise of its discretion unless it reasonably believes that (a)-(c) above will be satisfied.*

**Discussion:** Consistent with our comments on Considerations (c) and (d) above, it is important that the application of Principles 9-11 takes full account of the sophistication and circumstances of the customer receiving the service. For example, it is likely to be inappropriate for a firm to have to gather the same amount of information about a sophisticated institutional client as it would a private individual in order to advise on an identical type of transaction. The application of the Principles also needs to take account of the circumstances in which any recommendation is made; it should not catch, for example, the exchange of trading views. In the case of portfolio management rather than *ad hoc* investment services, the client would not necessarily need to understand any particular investment, but should understand the overall investment strategy, objectives and risks related to the portfolio managed on his behalf.

#### 3.2 Information before transacting with or for a customer

**Principle 12.** *Subject to Principle 13 and to Section 3.3 below, before transacting in an investment with or for a customer (or upon recommending the transaction to the customer) intermediaries should take all reasonable steps to satisfy themselves that the customer has sufficient information on the investment in a form the customer is reasonably likely to understand so that the customer*

***has had an adequate opportunity to understand the risk/reward profile and other material characteristics of the relevant investment before making any decision whether to enter into the relevant transaction. Where the customer subsequently decides to proceed, the intermediary is entitled to assume that the customer has properly considered the transaction and its risks.***

*Means for Implementation:*

*In deciding what information needs to be provided, how and when, intermediaries should have regard to the IOSCO Principles for Disclosure of Key Information in regard to CIS Prior to the Point of Sale, as appropriate to the type of customer concerned.*

**Principle 13.** ***The information requirements in Principle 12 do not apply where the decision to transact is made in the ordinary course of performing a discretionary investment management mandate in accordance with its terms.***

**Principle 14.** ***Where the market intermediary makes a personal investment recommendation to the customer, it should communicate clearly to the customer the basis of the recommendation and retain a record.***

**Discussion:** As reflected in Principle 5, product producers also have an important role to play in ensuring that product information provided by intermediaries to customers (whether prepared by the product producer or the intermediary) is of an appropriate quality.

### **3.3 Dealing where the service does not involve an assessment of suitability**

**Principle 15.** ***Where a customer asks an intermediary to undertake a transaction in relation to an investment other than on the personal recommendation of the intermediary, the intermediary should consider whether, from what it knows of the customer, there is anything that clearly suggests the customer does not have a sufficient level of knowledge or experience to assess the merits of that transaction for the customer. However, if the customer still decides to proceed, having been given sufficient time to consider the issue properly, the intermediary can execute the transaction and is not under a duty to prevent it.***

*Means for Implementation:*

*Where the intermediary reasonably believes that the customer may not have a sufficient level of knowledge or experience it should (but is not obliged to) consider whether to notify the customer that it would be prudent for the customer to take professional investment advice.*

**Discussion:** Principle 15 applies in relation to a proposed transaction in an investment of a sort on which customers of the sort concerned would commonly take advice where there is no indication that customer has received professional investment advice from elsewhere.



### 3.4 Dealing

**Principle 16.** *Subject to complying with a customer's express instructions, when executing an order for a customer, an intermediary should take all reasonable steps to achieve "best execution".*

**Discussion:** The concept of "best execution" has received considerable regulatory and industry attention and has been subject to detailed definition, with regional variations. It is not feasible to capture all of that in high level principles of this sort. By including the expression in quotation marks, we have sought to reflect the fact that it should be understood as a term of art, by reference to local usage of that expression or other expressions designed to describe a similar concept.

## 4. Principles applying post-transaction/ on an ongoing basis

### 4.1 Information once a customer has acquired an investment

**Principle 17.** *The intermediary should provide information on the performance and value of the investment (and where it is comprised in a portfolio, on the portfolio) which is appropriate in frequency and detail in the context of the services the intermediary has agreed to provide on an ongoing basis.*

*Means for Implementation:*

*There is no on-going duty to assess the suitability of any investment except as contemplated in Principle 18.*

*A firm that provides no more than a custody service should account regularly to the customer for the investments it holds, but is not required to provide performance information.*

**Discussion:** Where such a service is being provided, the intermediary should also respond appropriately to customers' information requests, bearing in mind that providing additional information may have a cost for the customer.

### 4.2 Ongoing suitability assessments

**Principle 18.** *Where the intermediary and customer expressly agree, an intermediary should assess the suitability of an investment the customer has acquired as a result of its personal investment recommendation or the exercise of its discretion on behalf of the customer at such intervals as the customer and intermediary may agree.*

*Means for Implementation:*

*This is most likely to be the case in relation to the provision of a discretionary investment management service where the suitability assessment is generally likely to be on-going. However, it may also be the case in relation to an advisory service if, for example, the intermediary and the customer agree that the intermediary that gave the original advice will also provide a periodic*

*review. The factors relevant to the original assessment will generally be the same for any subsequent assessment. However, information obtained about the customer for the purposes of the original suitability assessment should be revised as appropriate by reference to the on-going service to be provided.*

**Discussion:** It is critical that this Principle should only apply where there is an express agreement between the intermediary and the customer providing for an on-going service of this sort post-transaction.