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Dear Sir

JAC Response to FSA Consultation: Retail Product Development and Governance – Structured Products Review (the “Response”)

This paper responds to FSA Guidance Consultation: Retail Product Development & Governance – Structured Products Review (the “**Guidance Consultation**”) where proposals are made to produce guidance on the product approval, development, processes and governance relating to structured products sold to retail investors (the “**Proposed Guidance**”). The Joint Associations Committee on Retail Structured Products (the “**JAC**”)¹ welcomes the opportunity to comment on the proposals set out in the Guidance Consultation. We agree with the objective of consumer protection and fully support an appropriate and proportionate regulatory approach to product governance to achieve this objective.

The members of the JAC comprise a large proportion of the major firms involved in the creation, manufacturing and distribution² within the EU of retail structured products³. The Guidance Consultation covers and the JAC focuses on structured capital at risk products (SCARP), non-SCARP investment products and structured deposits sold to retail investors (“**Structured Products**”).

We consider that the proposals set out in the Guidance Consultation must also be considered in light of:

- the Discussion Paper (published in January 2011) (“**DP11/1**”) and Feedback Statement (published in June 2011) (“**FS11/3**”) on the broader issues surrounding product intervention⁴ including the JAC Response dated 21 April 2011;
- the European Commission consultation paper on the review of the Markets in Financial Instruments Directive published December 2010 (“**MiFID Review**”) and the MiFID II Legislative Proposal published on 20 October 2011 together with the JAC Response;⁵
- proposals by the EU Commission on Packaged Retail Investment Products (“**PRIPS**”);
- the proposed intervention powers of the Financial Conduct Authority (“**FCA**”) set out in the HM Treasury consultation paper: “A new approach to financial regulation: building a stronger system” (February 2011) (“**HMT Consultation**”) and the Consultation, White Paper and draft Bill published by HM Treasury in June 2011.

¹ The JAC is sponsored by multiple associations with an interest in Structured Products. In the first instance, queries may be addressed to ajacobs@isda.org.

² In this regard, distribution is primarily carried out by members of the Structured Products Association.

³ This paper represents the views of members of the JAC with regard to the implications of the FSA Consultation in the UK and EU. As such, this paper should not be taken to represent views regarding retail structured products in any other jurisdictions.

⁴ http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf and http://www.fsa.gov.uk/pubs/discussion/fs11_03.pdf

⁵ Accessible on ISDA website [here](#).

- the JAC Principles “Retail Structured Products: Principles for managing the provider-distributor relationship” (“**JAC Principles**”) which seek to address issues that firms have in practice found helpful to consider to ensure good consumer outcomes when performing the function of either provider or distributor in connection with the process of delivering Structured Products to retail investors. The JAC has also developed principles that apply to the distributor-individual investor relationship, i.e. the “Structured Products: Principles for Managing the Distributor-Individual Investor Relationship” (“**JAC Distributor Principles**”). The JAC Principles and JAC Distributor Principles are annexed at Schedule 2.

As well as responding to the questions raised in the Guidance Consultation we have also sought to address, at a high level, key issues relating to product intervention that we believe are of relevance to product governance generally and which we set out in Schedule 1 to this Response. We summarise here the key overriding points the JAC raises which provide the background and context to the more detailed comments raised in the Response as follows:

- The market for structured products is highly competitive with a number of product providers and financial institutions competing for business from retail intermediaries. The JAC would suggest that the Proposed Guidance recognises the practical and legal challenges in allocating responsibility across the distribution chain and would highlight the importance of the identification of the correct entity to which regulatory responsibility should be allocated by the FSA. This is of particular importance in a Reverse Enquiry or Counterparty scenario as defined later and outlined further in Section 4.2 (Product approval procedures) and Section 4.3 (Identification of target market) below. The FSA could protect consumers in this area, by also imposing product governance standards on distributors, to the extent they are designing products, identifying target markets and involved in the product development process. In addition, we would stress the importance of the point of sale disclosure obligations and the need for distributors to assess client needs and determine the appropriateness and, where applicable, suitability of a product for each client;
- Product providers acknowledge the points raised by the FSA on product governance and will typically have detailed internal product approval processes in place to scrutinise sales of Structured Products targeted at retail investors. Product providers consider the appropriateness of Structured Products for generic target markets by reference to broad client types. Coupled with a rigorous process for due diligence on the nature and sophistication of the distributor to ensure that the channels of distribution are robust, these processes mitigate the risk of investors being sold products they do not understand.
- Whilst back-testing and scenario analysis is generally carried out by market participants pre-sale, further clarity is requested in relation to additional stress-testing which the FSA envisages in the Guidance Consultation. Any forward-looking assessment or performance analysis is necessarily subjective and investors will have different needs depending on their risk/reward profile and appetite. Any additional modelling which is being requested should be carefully considered in order to ensure that the goal of balancing investor protection with commercial realities, and an appropriate cost/benefit analysis, is achieved.
- The JAC would urge the FSA to follow the approach of the Commission on PRIPS in ensuring that retail investor protection standards are consistent across all wrappers, regardless of the legal form of delivery.

Yours sincerely,



Timothy R Hailes
Chairman, Joint Associations Committee

DETAILED COMMENTS

1. Structured Products market

As noted in the Guidance Consultation, the market for Structured Products is growing in popularity and amongst other things provides for the needs of investors for long-term financial security and, in particular, retirement funding. Firms engaged in this market perform a critical social function. Structured Products are designed to meet retail investors' risk/reward needs and offer unique benefits that cannot be obtained from other forms of investment. The availability of Structured Products also encourages competition and consumer choice. The risk/reward profile of an individual investor is rarely addressed by reference to one product and, equally, the risk/reward profile of one product should not be judged on a qualitative basis without reference to an individual investor's general risk appetite and portfolio. However, where regulatory action is needed, it is important for it to be placed in context so that it enhances the product governance processes and structure in a constructive way to enhance investor protection.

2. Scope – products covered

We note that the FSA has limited the scope of the Proposed Guidance to Structured Products (including structured capital at risk (SCARP), non-SCARP investment products and structured deposits only). The definition of these products is, however, unclear and we would welcome further discussion on the intended scope of these terms. Moreover, the JAC believes that the legal vehicle used to deliver a Structured Product should not be the sole determinant in deciding which regulatory framework is applicable to that Structured Product and that a similar risk/reward can be achieved through many different legal forms of Structured Product. There should, therefore, be a coherent and consistent approach to the investor protection standards applicable to all forms of products delivering the same exposure to investors. The JAC believes in creating a level playing field with regard to the disclosure and conduct of business requirements for all Structured Products and would advocate that the FSA adopt a similar approach to the EU Commission with respect to its work on PRIIPS in applying a consistent framework regardless of the legal wrapper through which the product is sold.

Section 2: Summary of JAC response on scope

- **The JAC questions the merits in the FSA focussing only on SCARP, non-SCARP investment products and structured deposits sold to retail investors in the Guidance Consultation. The JAC would advocate an approach similar to that of the Commission in relation to Structured Products and its work on PRIIPS in applying a consistent regulatory framework to products delivered to investors in a packaged or structured form.**

3. Definition of “retail”

3.1 MiFID and PD exemptions: We would welcome clarification as to whether the FSA is proposing to apply the Proposed Guidance to the class of retail client defined in MiFID or to retail/public offers as set out in the Prospectus Directive⁶ (“PD”), (to exclude, for example, offers with minimum denominations of EUR 100,000 and offers to less than 150 offerees per EU Member State). In order to avoid inconsistencies, we would propose that the interpretation of “retail” in the Proposed Guidance refers to a retail/public offer and allows exemptions based on the PD. In addition, the JAC requests that consideration is also given to linking the scope of the Proposed Guidance to retail consumers only.

3.2 Discretionary asset management: The JAC believes that the Proposed Guidance should not extend to the situation in which a product provider sells a Structured Product to an institution that acts in

⁶ 2003/71/EU as amended by the Amending Directive 2010/73/EU.

the capacity of a discretionary asset manager (i.e. where there is no on-sale of the product, but the asset manager may allocate securities between client accounts without referring to the underlying clients, acting under the terms of its discretionary client mandates). In these circumstances, there is no on-sale of the product to a retail investor and the product provider has no visibility to the types of underlying accounts that the discretionary asset manager is allocating to.

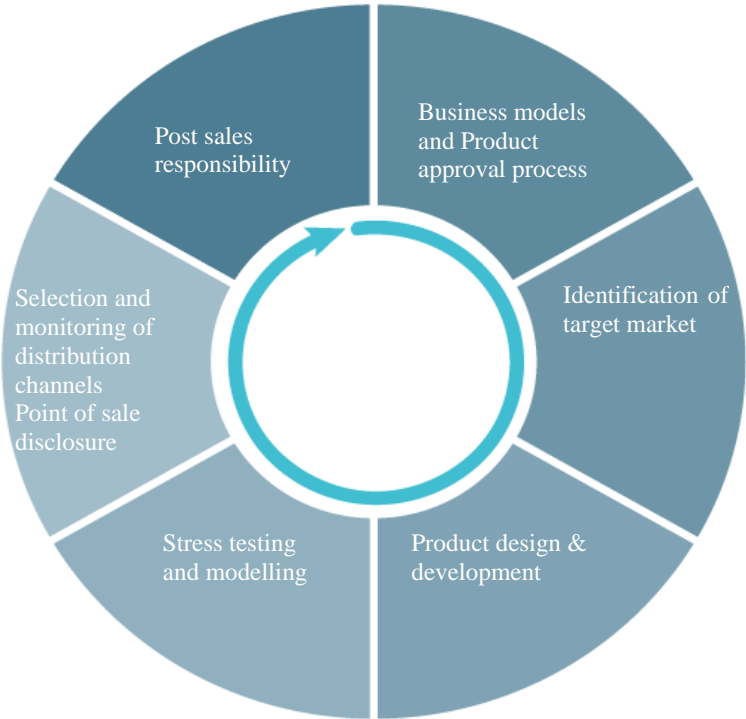
Section 3: Summary of JAC response on scope – definition of retail

- **The JAC would suggest that the PD exemptions are also applicable in the context of product governance.**
- **The FSA should also give consideration to limiting the scope to retail consumers only.**

4. Product development and governance

In this Section 4, we have responded to each of the areas of the Guidance Consultation in turn.

We have set out below a chart showing the product life cycle as outlined in the Guidance Consultation .



4.1 Business models⁷

We note that the FSA believes that firms focus too much on their commercial position at the expense of consumer outcomes. The JAC would respond that member firms, in conjunction with distributor entities, should have detailed processes in place to ensure consumer protection, examples of which are set out in more detail in section 4.2 below. We believe that the Proposed Guidance should also require appropriate product governance for distributors.

⁷ Section 5, Guidance Consultation

4.2 Product approval procedures⁸

(a) Current processes

We note the FSA's comments on the current product approval process carried out by firms and, in particular, that the structure and methodology of these processes varies across firms. The JAC would highlight Principle 3 of the JAC Principles which requires product providers to consider what internal approval processes are appropriate for Structured Products including sign-off, product structuring, risk-reward and distribution. In addition, firms would generally also operate within a corporate culture which reflects reputational risk to the institution as well as more generally a value control process on risk/reward in relation to products targeted at retail investors. Therefore, we would expect product providers to have detailed processes and procedures in place for approving new Structured Products, in order to ensure that the product approval process is not compromised as a result of commercial, time or funding pressures. The process should also allow for review and challenge by the risk and compliance functions so that the entire product governance process reflects balanced values across all functions and is not compromised by interests of the business, such as the following:

The Product

- Product complexity – is the product inherently too complex for certain contemplated categories of investors?⁹
- Principal protection – in what circumstances is principal at risk? How much could an investor lose?
- Liquidity risk – is there secondary market liquidity?
- Regulator position – have regulators expressed any views on the specific type of product?
- Product provider acting as principal – would the product provider sell the product directly to investors?
- Novelty of the product to the relevant market – what other participants are selling the product in the market?

The Distributor

- Know Your Distributor (KYD) – assessment of the distributor's reputation and expertise;
- Assessment of appropriateness/suitability standards;
- Intermediary's capitalisation, regulatory status and standing in the relevant market;
- Marketing materials and documentation review;
- Type of targeted investor.

⁸

Section 6, Guidance Consultation

⁹

See also section 4.4(b) below in relation to an analysis of complexity versus risk.

(b) Product origination - identification of product provider

There are three key scenarios identified by the JAC with respect to product origination and we would urge the FSA to take account of each scenario when considering how to allocate regulatory responsibility relating to product governance:

(i) Reverse Enquiry and Counterparty scenarios

The vast majority of Structured Products are capable of being produced by a variety of providers. In relation to these, product providers may be approached by a distributor, who will often determine what characteristics a product should have. There will generally be a competitive process between different product providers to design a Structured Product that meets the distributor's requirements whereby, the distributor will, in most cases, have pre-defined the key terms of the product (including the pay-off, wrapper and the underlying). Therefore, there is input from distributors at the product design stage and the creation of the Structured Product is driven by the needs of the distributors, as well as their clients, a so-called "**Reverse Enquiry**". Alternatively, a third party product provider may approach one or more investment banks to manufacture a security for it in connection with its own product or investment plan offering. In this case, we would consider the product provider to be the manufacturer with primary regulatory responsibility as such and the investment bank would be a "Counterparty".

We note section 4.21 of the FSA Feedback Statement (FS11/3) on Product Intervention which acknowledges these methods of product origination.

In addition, increasingly, wrapper platforms are being used by IFAs and other intermediaries to effect sales of Structured Products. In such circumstances, the product manufacturer will have no visibility of the specific end-investor and it would be helpful if the FSA gave further consideration to how the Proposed Guidance could be applicable.

(ii) Product provider design

In other cases, the product provider designs a new Structured Product on its own initiative, for example, following internal research and development. In this scenario, the JAC agrees that it is the product provider which would, therefore, be required to carry out product governance and to approve the structure of the product and mechanics as appropriate for the target market.

(iii) Joint product origination

The third option is where the product provider and the distributor play a joint role in scrutinising the product governance process. In such a scenario, the parties would agree which entity would be required to carry out the product governance procedures (or which entity will carry out specific elements of the product governance, some of which may be shared responsibility). For example, the distributor would usually be responsible for the point of sale disclosure, but will rely on the manufacturer to assist by providing it with certain information.

The JAC would urge the correct entity to be identified as carrying out each element of the product governance requirements and, in particular, to highlight the Reverse Enquiry and Counterparty scenarios.¹⁰

JAC members generally take the view that whilst a manufacturer of a product should bear responsibility for ensuring the product 'does what it says on the tin' (i.e. performs in accordance with the methodology and formulae outlined in the documentation), it may be another entity within the value chain which will take responsibility for the wider product governance processes or specific elements of it. We believe that the concern of the FSA should be focussed on ensuring that the value chain generates the right outcome and provides protection for the customer; however, the allocation of responsibility for delivery across that value chain should be subject to freedom of contract between the parties.

Regulators should bear in mind the method of origination for determining product features when creating and allocating regulatory obligations, and also when exercising supervisory and enforcement powers; the person or persons who undertake product design should bear responsibility in relation to the design of the product to meet identified consumer needs and the distributor should continue to bear point of sale responsibilities. The JAC members, therefore, believe that the Proposed Guidance should differentiate between Reverse Enquiry and Counterparty scenarios and the position where the product provider is designing the product from the outset and then engaging distributors for marketing purposes. This approach is consistent with the FSA's guidance paper on RPPD¹¹ which states in paragraph 1.15 (1) that "It is possible that a provider creates a product to meet criteria or designs specified by a distributor. In such instances, many of the responsibilities fall to the commissioning distributor, as "retail manufacturer" of the product....That said, the pure manufacturer must act with due skill, care and diligence."

Section 4.2: Summary of JAC response

- **The FSA should ensure that the method of origination (and in particular the Reverse Enquiry and Counterparty scenarios) is reflected in the allocation of regulatory responsibility for product design, development and sales approval processes.**
- **In many cases it is the distributor or overall product manufacturer which will need to carry out the more lengthy product approval process and business models analysis and not the "pure" manufacturer or "counterparty".**

4.3 Identification of target market¹²

(a) Knowledge of target investor

Following on from product origination above, the JAC would propose that there is a distinction drawn between the following in identifying target markets:

(i) Reverse Enquiry and Counterparty scenarios

The JAC would suggest that the Proposed Guidance recognises the practical and legal challenges in the distribution chain (rather than adopting a one size fits all approach). The FSA could protect consumers in this area, by also imposing product governance standards on distributors, to the extent they are designing

¹⁰ We refer the FSA to our response on DP06/4 on the Roles and Responsibilities of product providers and distributors for the fair treatment of customers (<http://www2.isda.org/asset-classes/structured-products/>) as well as the JAC Principles including Principle 10 on the delineation of responsibility between product provider and distributor.

¹¹ Role and Responsibilities of Product Providers and Distributors.

¹² Section 7, Guidance Consultation.

products, identifying target markets and involved in the product development process.

The FSA proposes that a product provider take into account certain factors when identifying target markets (e.g. risk profile, investment objectives, financial situation, risk/reward trade off and financial capability and experience) which we believe would be more effectively carried out by the distributor. In particular, in the Reverse Enquiry scenario, the product provider will have little visibility as to the particular target market (an example of this would be distribution into Switzerland where the distributor will not share client or target information owing to bank secrecy laws). In such circumstances, the JAC would expect that it is the third party product provider or distributor which would be the entity required to comply with the product governance rules and the identification of the target market (and not the entity which is carrying out a “pure” manufacturing or “Counterparty” role).

(ii) Product provider designed

In the case of a product provider designed product, most product providers would undertake a broad analysis of an appropriate target market on a hypothetical basis, which, coupled with a rigorous KYD analysis outlined below, ensures that, provided that distributors are satisfying their obligations, investors are sold products which are suitable for their risk/reward profile. Product providers will not, however, have direct access to detailed market knowledge of the specific customers (even where the provider has a retail bank or distributor within its group). Information on specific customers which would be available to the distributor would not, for client confidentiality and other reasons, be available to a product provider and, therefore, any identification of a market could only be undertaken on a generic basis. Although there are some broad categories of market which are identified (e.g. high net worth individuals), currently, there is no broadly accepted definition of “target audience” or “market” within which firms operate which could be helpful in this area.

(iii) Know Your Distributor (KYD)

In addition to a generic product assessment, the JAC believes that it is vital that product providers carry out a rigorous KYD process and ensure there is sufficient due diligence on the part of the distribution chain which they interact with and an understanding of the specific product distribution plan more generally. Ensuring that the channels of distribution are robust would mitigate the risk of targeting investors for whom a product is not suitable. For example, a private bank would be likely to have more sophisticated clients than, for example, a consumer bank or IFA. Most firms conduct “Know Your Distributor” due diligence including assessments of whether distributors are appropriate distributors for placing particular product types and we would refer to JAC Principle 7¹³.

¹³

We refer to JAC Principle 7 (<http://www2.isda.org/asset-classes/structured-products/>). “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.”

(b) Recognition of need for balanced portfolio

Structured Products provide a vital mechanism for certain ultra high net worth, sophisticated retail investors to take specific positions or market views. Any risks should, therefore, be analysed in the context of a balanced investment portfolio. In designing products, product providers will look at the generic requirements of their targeted investor categories (whilst also balancing commercial considerations such as the assumption of risk and hedging requirements). However, as each investor will have their own risk/reward profile and appetite and will be looking at their own portfolio, a product provider will not be aware of the objectives of each investor (and, indeed, some investors may take a contrary market view); nevertheless this should not preclude investors from buying higher risk products (as such a purchase will be subject to an appropriateness/suitability assessment by a distributor). Some high risk products may be suitable for investors who otherwise have a low risk portfolio or who themselves have extensive investment experience.

Section 4.3: Summary of JAC response

- **Identify correctly the entity which should carry out identification of target markets and, in particular, acknowledge Reverse Enquiry and Counterparty scenarios.**
- **Acknowledge in the Proposed Guidance that an analysis of a generic target market coupled with a rigorous KYD process reflecting the nature and sophistication of distributors provides a key element of investor protection.**
- **Acknowledge the need for investors to have a balanced portfolio and how Structured Products can assist investors in taking specific positions or market views.**

4.4 Design and development of product features¹⁴

We note the FSA's points with respect to pricing, fees and commissions and how these must be fair from a customer perspective. We also note the FSA's previous position on price intervention in the Discussion Paper Feedback Statement (FS11/3).

(a) Pricing

The JAC does not support the price regulation of products and we are not aware of other significant markets where the regulators are involved in the pricing mechanisms. The UK Structured Products market is competitive and market forces should act as a reasonable constraint on product manufacturers (and indeed distributors). If products are transparent and easily comparable, competition between product providers should keep prices low without the need for price interventions. There is no evidence of any failure necessitating intervention, and we are unclear on what grounds the FSA (or Financial Conduct Authority ("FCA")) would intervene or how the FSA or FCA would seek to benchmark (for example, by reference to, fees, margin, spreads or revenue). Many Structured Products are by their very nature bespoke and distributors as well as potential investors have the ability to shop around. There must be absolute clarity on the scope of the FCA's powers and the circumstances in which price interventions might be exercised, providing more clarity and certainty for firms. Absent this clarity, there is a real risk of an increasingly uncertain environment with unintended consequences, including defensive firm behaviour which is damaging to the market and consumers.

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We note from the Guidance Consultation that the FSA is proposing that the design process should take account of the total gross returns of the product split between the different stakeholders in the product and whether the distribution including fees and charges is fair from a customer perspective. In addition, we note from the Feedback Statement that the FCA may be involved in pricing of products. We believe that the product provider's effective product governance process together with the distributor's point of sale obligations to investors should govern the pricing of a product and ensure a fair outcome for consumers.

We have also considered (i) embedded margins and (ii) secondary market pricing.

(i) Margin of product provider

Defined return Structured Products are capable of meeting consumer needs that may not be met as effectively (or at all) by other investment products.

Reflecting the assumption of risk by the product provider, and the value add provided by the product provider, the Structured Product will typically include an embedded margin. This embedded margin on a Structured Product is not, therefore, the same as the profit to be made on a Structured Product because it is at risk, and may not be reached over the life of the Structured Product, being dependent on the characteristics of the Structured Product, hedging and its pricing model. In addition, the risk/reward to the investor is not affected by whether or not the product provider reaches, exceeds or falls short of the embedded margin (including where the provider ultimately suffers an economic loss on the product). The margin made (or lost) on a Structured Product is not comparable to, for example, an asset management fee for the product provider as such a fee is deducted from the net asset value of the product by way of fixed percentage cost and regardless of investment performance.

In relation to a defined return Structured Product (i.e. a product where the pay-off is described at the outset by reference to a specific asset, index or other value), an investor will receive at the pre-defined times (e.g. coupon payment dates, maturity) what the Structured Product documentation states the return on the Structured Product will be. These are marketed as "hold to maturity" Structured Products. As an accommodation to the needs of consumers, there may be a secondary market in the Structured Product. The basis on which the secondary market is provided should be made clear to investors and we would refer here to JAC Distributor Principle 7¹⁵. In relation to the availability of the secondary market, it also is generally made clear that, prior to the maturity of the Structured Product, the price an investor may receive for their Structured Product on the secondary market may not be the price the investor paid for the Structured Product (or price payable at maturity). It is, therefore, essential to ensure that investors understand the secondary market.

The assumption of risk and accordingly reward for the product provider is intrinsic to the delivery of the Structured Products and does not represent or give rise to consumer detriment provided that clear and broad disclosure is made as to the existence of the embedded product provider margin and its potential impact on secondary market pricing.

In addition, the overall price of a Structured Product should be a factor that is taken into

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JAC Distributor Principle 7 – “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.”

account by a distributor in their product selection and point of sale responsibilities when considering whether and how a Structured Product should be made available to their investor clients. It is important to delineate the responsibilities of a product provider and distributor when considering the appropriateness of the overall charge for a Structured Product.

(ii) Distribution fees

Distribution fees must be disclosed to investors by the distributors in accordance with the applicable regulatory requirements (including MiFID). We note that the Retail Distribution Review will impact the payment, and disclosure to investors, of fees. This may rectify the perceived market failings around pricing and disclosure of such fees.

(b) Complexity vs riskiness

The FSA notes that there is a shift towards new legal structures and more complex pay-off profiles without always a clear consideration of whether these are of genuine benefit to consumers. The Guidance Consultation goes on to state that if a Structured Product has complex features which are difficult to explain to customers, firms should take particular care with the use of non-advised distribution. The JAC agrees with the objective of increasing transparency and reducing the complexity of information received by distributors and retail investors in relation to Structured Products. Firms would generally have in place through existing governance, a review and measure of complexity of the product by reference to the knowledge and experience of the relevant distributor and the generic target market (e.g. multiple payout conditions or options combined, non-linear payout structures, algorithmic based methodologies and certain proprietary indices).

However, the JAC would like to highlight its established view that the complexity of a Structured Product does not necessarily equate to, or directly correlate with, the riskiness of a Structured Product. It is essential that the key risks of a Structured Product and an understanding of when a return is payable (or not) must be accessible to the investor; however, describing to a retail investor in detail the components of the Structured Product which result in capital protection or payment of returns is neither required nor helpful. We, therefore, see an increase in transparency as an adequate safeguard against any concern for ensuring retail investors understand the products that they propose to acquire, rather than requiring a reduction in the complexity of Structured Products distributed to retail investors.

Section 4.4: Summary of JAC response

- **The product provider's product governance process, in conjunction with the obligations of the distributor, should govern the pay-off of a product and determine whether there is a fair outcome for the investor.**
- **The JAC believes that complex products are not necessarily unsuitable for distribution to retail investors; it is instead important to ensure that investors receive sufficient, clear and understandable information in relation to a product, including in relation to the risks and rewards associated with a product, to ensure that a Structured Product is accessible to retail investors.**

4.5 Stress testing and modelling¹⁶

(a) Scenario analysis and quantitative modelling

The Proposed Guidance provides that firms stress-test products to consider how a product might perform under a variety of conditions and these should be forward-looking as well as back-tested. The Proposed Guidance contemplates that firms should model outcomes from a consumer's perspective, consider particularly challenging situations but also be flexible enough to be revised to take into account current market conditions and projections. The JAC would highlight the following points by reference to examples where possible:

Principles-based approach: The JAC members believe that a principles-based approach would be advisable in this area. The relevant firm could apply general principles to the context of a particular product to determine what types of analysis would be appropriate. The diversity of product offerings makes it impracticable to impose an overarching rule.

Performance analysis: The JAC request further clarity from the FSA with respect to what is meant by a stress-test. The stress envisaged by the Proposed Guidance is more a “performance analysis” or a test to see whether the product will perform if held to maturity. The performance at maturity of a Structured Product is defined by a formula which is generally by reference to a performance of the underlying indices or reference quantities making the performance of the note fairly straightforward to compute at maturity. One way of meeting the FSA’s stress test requirement is to perform a Monte Carlo simulation where the performance of the underlying indices or other reference points is simulated in a “real” world (reflecting specific risks) rather than in a “risk-neutral” world (the latter being the “world” where most Structured Products are priced). However, this would require a forward-looking assessment of the appropriate rates of growth (or rates of return) for the reference indices which is problematic as the selection of these rates is almost entirely subjective. Generally, different investors will have different projections on the performance which would make the expected return on the Structured Products attractive to them.

The position should be contrasted with the position in the asset management industry where, although there is periodic reporting required in order to reflect the benchmark of the fund performance, there are no requirements to carry out stress-testing to the same degree but rather scenario analysis is preferred.

Principal protected products¹⁷: For principal protected Structured Products, a key risk involved in the product is that the issuer becomes insolvent and is unable to repay the principal at maturity. This risk is already required to be clearly disclosed and the prospectus for the offer would provide detailed disclosure on the issuer enabling investors to have all relevant information before making their investment decision. In terms of stress testing, current and historical credit spreads on the issuer can be examined but, otherwise, it is doubtful that any other stress-testing can usefully predict the risk of an issuer insolvency and the Proposed Guidance should acknowledge that it is appropriate for more limited stress testing to be carried out in relation to principal protected products.

Suggested approach: The JAC would suggest that the focus for the product provider should be on back-testing, scenario analysis and/or a clear explanation of the product and

¹⁶ Section 9, Guidance Consultation

¹⁷ Consider a principal protected note linked to the FTSE where the investor receives the positive performance of the FTSE at the end of 5 years plus their initial investment amount. If the two issuers have significantly different credit spreads then the product from the issuer with a wider credit spread will have a higher upside potential because this product should have more embedded options (or higher participation in the upside of the FTSE) reflecting the fact that the zero coupon bond of the provider with higher spread will be less than that from the provider with a lower spread and if the same projection of the FTSE is applied to both and if both issuers are solvent on the maturity of the note.

all the possible outcomes rather than attempting to predict how indices, or other reference points to which the product is linked, will perform.

(b) Benchmarks

The Guidance Consultation also considers the option of finding suitable benchmarks for Structured Products in relation to pricing. We are concerned that this may inadvertently lead to potentially inappropriate benchmarks because of the inherent difficulties in identifying an appropriate benchmark, compounded further by situations where even a slight difference in the characteristics of a Structured Product compared to the benchmark may render any comparison with the benchmark inappropriate for investors. We note the example of “Good Practice” provided in the Guidance Consultation of firms applying a quantitative cash comparator test to all structured deposits and investment products that were entering the product design process. In such cases, the JAC questions which rate should be used (e.g. the issuer’s rate, base rate or other rate). In addition, for certain products (as acknowledged by the FSA)¹⁸, cash may not be a relevant benchmark and “forecasting” is thought to be more appropriate. Clarity is requested in relation to forecasting and, in particular, whether this is intended to be conducted internally by the product provider and/or provided to investors. Forecasting (essentially producing an expected value of a product in numerical terms) would generally be unsuitable and potentially misleading for a product where the return fluctuates with market conditions. It would be helpful if the Proposed Guidance clarifies that expected values are not required.

Section 4.5: Summary of JAC response – stress testing

- **The JAC requests a clearer articulation of (a) the purpose and focus of quantitative modelling (for example, any modelling should be generic in nature and not tailored to a specific investor) and (b) as a practical matter, what type of modelling could produce the desired outcome to investors**
- **The JAC would suggest that the focus for the product provider should be on back-testing, scenario analysis and a clear explanation of the product and all the possible outcomes rather than attempting to predict how indices, or other reference points to which the product is linked, will perform.**
- **Caution should be exercised in applying benchmarks or requiring forecasting and forward looking analysis to Structured Products where the outcomes may not provide a meaningful comparison to investors.**

4.6 Point of sale disclosure – information to distributors and consumers¹⁹

- (a) Selection of distribution channel: The Proposed Guidance suggests that Management Information (“MI”) should be analysed and collated by product providers²⁰. As distributors are often unwilling or unable to disclose certain information to a product provider, it may be difficult to obtain MI as envisaged by this section.
- (b) Reverse Enquiry and Counterparty scenarios: We believe that paragraph 11.7 of the Proposed Guidance, which sets out the detailed information which product providers should provide to distributors and paragraph 11.9 which covers the provision of training for distributors, are appropriate only where the product provider has designed the product and approached the distributor and not in a Reverse Enquiry or Counterparty scenario.

¹⁸ Paragraph A1.5, Annex 1, Guidance Consultation

¹⁹ Section 10, 11 and 12, Guidance Consultation

²⁰ Section 10.2, Guidance Consultation

- (c) Sophistication of distributors: We believe there should be an acknowledgment that the application of paragraphs 11.4 (a distributor is unlikely to be able to access information on its own) and 11.6 (information provided to a distributor must be understood by a recipient within the distributor with the lowest level of knowledge) of the Guidance Consultation, will depend on the sophistication of the distributor and that the distributor should also be responsible for ensuring that it understands the products that it distributes.

4.7 Post-sales responsibility²¹

Nature and level of post-sales information: The JAC supports the requirements for product providers to monitor products that have been targeted at retail customers, respond to any requests for information from distributors and ensure that ongoing disclosure is available. However, since the Structured Products are generally intended to be held to maturity, the level of post-sales information may be required to be tailored according to the nature and sophistication of the customer. As with other aspects of interface with the retail investor, this requires knowledge as to the investor's understanding, which the distributor is in the best position to assess.

Alteration of terms: We would highlight that the FSA's example of "Good Practice" suggests ongoing active management of a product post-sale which may not be possible or desirable under the terms of an investment (e.g. where a structured note is held through a clearing system and/or investor consent is required to change the terms of a product).

We believe that the proposed ongoing disclosure obligations place onerous responsibilities on product providers in relation to consumers (which would be more appropriate to apply to distributors). Although it appears that certain disclosures should be made by product providers to distributors (as the product provider will have the most information in relation to a product), this should not extend to requiring a product provider to contact investors directly. In addition, care would have to be taken in relation to ongoing disclosures that are made as they could give rise to reactions from consumers and distributors which may not be in their best interests (e.g. incurring penalties for early redemption). We would envisage that ongoing disclosures would also increase costs for a client due to the risk involved for a product provider in determining what should be disclosed and the level of disclosure.

We do not believe that it is necessary to impose additional requirements above those which are typically currently provided in the terms and conditions.

These provisions will also need to tie in with the MiFID II Legislative Proposal which currently requires investment firms to provide periodic communications to clients taking into account the type and complexity of financial instrument involved and the nature of the service provided and include, where applicable, the costs associated with the transactions and services undertaken on behalf of the client.

Section 4.7: Summary of JAC response – post-sales responsibility

- **Any post sales responsibility should acknowledge the Reverse Enquiry and Counterparty scenarios and the direct relationship a distributor will have with the ultimate investor.**
- **Product providers cannot often interface with investors and where structured notes are held in a clearing system the identity of the investor will not be known.**
- **Any responsibilities should be consistent with existing responsibilities (PD/MiFID).**

²¹

5. Interaction with EU proposals

It will be essential to ensure consistency with current EU developments in relation to the sale of Structured Products.²² The JAC would urge the FSA not to front run or gold plate any such developments to ensure a consistent approach across the EU. To the extent that proposals supplement EU developments (for example the imposition of greater transparency obligations), we consider that it is not appropriate to address these at national level.

Existing point of sale obligations and clear, fair and not misleading communication rules under MiFID are also particularly relevant to the proposals under the Guidance Consultation. Our preference would, therefore, be to have standards determined at an EU level to ensure that there is a level playing field across Europe. As part of the MiFID Review it is also proposed that national regulators will have the power to impose product bans where there is a serious threat to financial stability or to market confidence in a Member State. Any power of the FSA to impose a ban on the sale of excessively complex Structured Products must be in accordance with any such powers.

6. Extraterritoriality

The JAC requests clarity on the territorial scope of the Proposed Guidance²³. Our understanding is that the Proposed Guidance applies when products are being offered to retail investors (potentially consumers only) in the UK (in a similar way to the RDR provisions). If the scope is intended to be wider, the JAC requests that the FSA provide further clarity, in particular on the following points:

- (a) UK branches: It may be argued that not all elements of the Proposed Guidance would apply to UK branches of EEA firms when offering products in the UK relating to systems and controls requirements (which would be a home state matter), e.g. guidance on the application of SYSC 3.1.1 and 4.1.1 and Principles 3 and 8, whereas the guidance on the application of COBS 4 would apply to a UK branch of an EEA firm.²⁴ We therefore query whether it is the FSA's intention for the guidance to apply in all circumstances where products are being offered to retail investors in the UK.
- (b) UK firm targeting non-UK investor: If there is an intention for the Proposed Guidance to apply to all FSA regulated firms that act as product providers of retail targeted products irrespective of where the end-investors are based, then FSA regulated product providers would have to comply with two sets of regulation (for example, where firms are structuring products to be sold to high net worth retail clients in other jurisdictions either within or outside the EU). Firms may then be subject to different, and potentially conflicting, regimes.²⁵
- (c) Article 4 notification: to the extent that the Proposed Guidance constitutes an additional "requirement" to MiFID, the UK would be required to submit an Article 4 notification.²⁶

²² In this regard the JAC intends to send the Response to the European Commission.

²³ See Annex 5 for Rule references

²⁴ Annex 5, Guidance Consultation

²⁵ For a UK MiFID investment firm, COBS rules that are within the scope of MiFID generally apply to its MiFID business carried on from an establishment in the UK regardless of where the client is based. They also generally apply to its MiFID business carried on from an establishment in another EEA State, but only where that business is not carried on within the territory of that State. For an EEA MiFID investment firm, COBS rules that are within the scope of MiFID generally apply only to its MiFID business if that business is carried on from an establishment in, and within the territory of, the UK.

²⁶ The UK is restricted from extending the scope of COBS rules that are within the scope of MiFID. Under Article 4 of the MiFID Implementing Directive (2006/73/EC), the UK may impose requirements additional to those in MiFID only in 'those exceptional cases where such requirements are objectively justified and proportionate so as to address specific risks to investor protection or to market integrity that are not adequately addressed by this Directive'. Additionally, in order for such 'gold-plating' to be lawful, the Article provides that one of two conditions must be met:

- (1) the specific risks addressed by the requirements are of particular importance in the circumstances of the market structure of the UK; or
- (2) the requirement addresses risks or issues that emerge or become evident after the date of application of the MiFID Implementing Directive and that are not otherwise regulated by or under Community measures.

Accordingly, Article 4 of the MiFID Implementing Directive means that any measure that the UK wishes to introduce over and above the scope of MiFID (including extraterritorial measures) must be designed to combat risks which would otherwise have an effect on the UK market (e.g. in terms of reputation, consumer confidence etc.).

About the Joint Associations Committee

The JAC is sponsored by multiple associations with an interest in structured products, including the International Swaps and Derivatives Association (ISDA), the International Capital Market Association (ICMA), the Association for Financial Markets in Europe (AFME), the British Bankers' Association, the Asia Securities Industry & Financial Markets Association (ASIFMA), SIFMA, the Associazione Italiana Intermediari Mobiliari (ASSOSIM) and the Institute of International Finance, Inc. (IIF). The members of the JAC comprise most of the major firms (both financial institutions and law firms) involved in the creation and, to some extent, distribution of structured securities which are distributed to retail investors.

About AFME

AFME advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). For more information please visit the AFME website, www.afme.eu.

About ICMA

ICMA represents financial institutions active in the international capital markets; its members are located in 50 countries, including all the world's main financial centres. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years, providing the framework of rules governing market practice which facilitate the orderly functioning of the market. ICMA actively promotes the efficiency and cost effectiveness of the capital markets by bringing together market participants and regulatory authorities. For more information see: www.icmagroup.org.

About ISDA

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 825 member institutions from 57 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

About UK SPA

The UK Structured Products Association (UK SPA) is an organisation established by companies that create and distribute structured products to the UK financial services market in order to provide a useful and responsive source of information, education and comment on structured products by promoting their contribution to effective financial planning.

The Association's formation is a direct response to the members' belief that structured products are sometimes misunderstood and misrepresented and that this lack of understanding can prevent structured products forming an integral part of financial planning for investors.

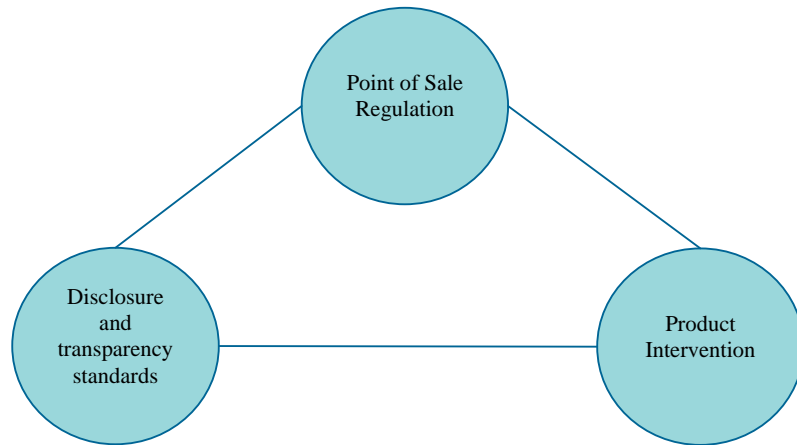
The UK SPA is committed to publishing research, information and educational material about structured products and so create greater acceptance about their potential.

The UK SPA is not a commercial organisation and education and research are its core activities.

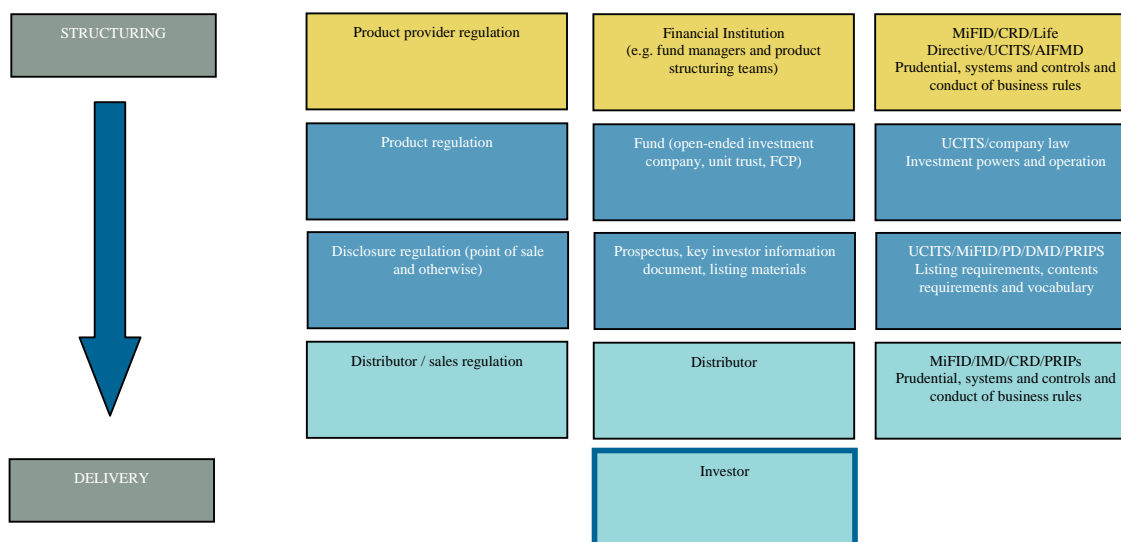
Schedule 1 – Product Intervention

Product intervention

Regulatory toolkit: Whilst the Guidance Consultation does not specifically relate to product intervention, we thought it would be helpful to include a reiteration of the position following the FSA’s Feedback Statement from which the Guidance Consultation follows. We consider that there are three key elements of the regulatory framework for Structured Products. These consist of (i) point of sale regulation, (ii) disclosure and transparency standards and (iii) product intervention.



We have highlighted below the existing legislative framework which applies to the sale and distribution of Structured Products (at a European level) and have also highlighted recent European developments. We consider that this is helpful to show the context in which any additional product intervention would be proposed.



Where clear disclosure about the nature and characteristics of some products is not enough to achieve the desired policy outcome, it must be considered what the appropriate regulatory response is.

Qualitative analysis of products: Since we understand that the FSA does not propose to review or subject to pre-approval every product type and how it might usefully be deployed in assisting an investor to achieve his or her investment objectives, an outright ban on the distribution of a particular category of products to retail investors is likely to prove a blunt regulatory tool that risks putting products beyond the reach of those for whom they might potentially be useful. In addition, there is a question over whether a regulator should be in a position to carry out a qualitative analysis of individual product types which might be of benefit to investors with a particular risk profile or within a specific strategy being followed within a balanced and diversified portfolio of assets.

Uncertainty: If the use of product banning powers were to become a serious prospect, it would be essential for the FSA to specify precisely when that power would be deployed and in what manner. Failure to do so would be likely to create considerable uncertainty in the market, potentially stifling constructive innovation and the generation of common goods in the form of new categories of investment product suited to the changing economic climate and changing investor needs.

Such powers would also need to be consistent with the current proposals set out in the MiFID Review which set out parameters for the power to ban the sale of a product for national regulators.

Criteria for product ban: We would like to suggest that the FSA should not consider any form of product ban unless the product is such that intermediaries that are likely to be involved in its distribution are not capable of understanding it sufficiently. This is because we consider that only the intermediary involved in the distribution of a product is sufficiently close both to the product and the client to be able to assess whether the two are compatible. Intervention, then, should only be necessary where the product is of a sort where it is likely to be beyond the ability of an intermediary to do that.

However, in principle, we consider that the best person to assess whether or not an intermediary understands a product is the intermediary itself. It should be clear that they have that

responsibility. This may be facilitated through the materials provided by the product provider or generally through the product provider and distributor's communications.

However, it is possible to impose limitations on the distribution of investment products without resorting to an outright ban, and this is the purpose of the MiFID “appropriateness” and “suitability” tests. The JAC fully supports the proposal that complex investment products should only be available to retail clients where they are sold by someone who applies one or other of these tests before any transaction takes place.

Product providers are not generally able to apply these tests, which under MiFID rightly fall to the firm that has the client interface. As noted above in relation to target markets, product providers can, however, consider generic appropriateness of products for particular parts of the investor market following confirmation from the distributor of the investor types that it intends to target.

Delineation of responsibility: Intermediaries and product providers have distinct, separate roles that need to be reflected in any new rules or guidance. Assuming a product has been properly described, we consider that product providers should not be held responsible for consumer detriment where products are suitable for some investors but not suitable for others. It is the distributor's role to ensure that products are distributed to investors for whom they are suitable/appropriate. It is most unlikely that a product will be suitable/appropriate for all of a distributor's clients, even where it has been developed with a particular sector of the market in mind which is serviced by a given distributor. As it is the distributor that has the direct interface with the individual investor, investor suitability/appropriateness of a product is a matter for distributors and is not a role that the product provider can play.

Exercise of powers: In any case, if powers are introduced to ban or limit the distribution of certain products, we are of the view that it is important that:

- (a) They are exercised in a transparent way– in particular, it is essential that the market should have sufficient certainty to carry on the business of providing a range of Structured Products to meet investor needs;
- (b) They are only exercised by the FCA after a careful analysis both (i) in order to test the proposal and (ii) to ensure that the power is used proportionately;
- (c) Adequate account is taken of the impact of a ban or restriction on other product-types that are already in the market - we are particularly concerned about:
 - (i) the potential unintended consequences of product banning in causing spurious claims in relation to products which may have similar characteristics but which were not missold and were in fact suitable/appropriate at the point of sale;
 - (ii) the banning of a product where sales have already been made to investors which will lead to uncertainty for product providers and distributors in relation to such sales.

Any uncertainty may have the unintended consequences of stifling constructive innovation and choice for consumers and increased costs of products to protect against the risk of a product being banned.

Schedule 2 – JAC Principles

23 May 2011

JOINT ASSOCIATIONS COMMITTEE COMBINED PRINCIPLES FOR RETAIL STRUCTURED PRODUCTS

In July 2007, the Joint Associations Committee on Retail Structured Products (the **JAC**)¹ published a set of principles for managing the provider-distributor relationship in retail structured products (the **PD Principles**). This was followed in July 2008 by a set of principles for managing the distributor-individual investor relationship (the **DI Principles** and, together with the PD Principles, the **Principles**). The Principles were drafted with the intent of achieving fair treatment for individual investors and clarifying the respective roles and responsibilities of the various parties involved in the creation and distribution process.

The years since 2008 have seen increased recognition by governments and regulators of the importance of a vibrant and well-functioning retail structured products market. However, the financial crisis has also impaired investor confidence. Such considerations have led to regulatory initiatives designed to improve investor protection in multiple jurisdictions.

The JAC is extremely supportive of such initiatives and is fully committed to working with governments and regulators to facilitate positive consumer outcomes. As such, the JAC has been an active participant in the consultation process in multiple jurisdictions².

Although published before the financial crisis, the Principles address many of the same issues as those sought to be addressed by such initiatives. Given this, the JAC feels that now is an appropriate time to re-release the Principles in order to both encourage their usage and help inform the current debate.

Accordingly, the PD Principles and DI Principles are restated in Annexes 1 and 2, respectively. The original sponsoring trade associations and their successors (the International Swaps and Derivatives Association (ISDA), the International Capital Market Association (ICMA), the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA)) have been joined by the British Bankers' Association (BBA), Associazione Italiana Intermediari Mobiliari (ASSOSIM), the Futures and Options Association (FOA), the Asia Securities Industry and Financial Markets Association (ASIFMA), the Institute of International Finance, Inc. (IIF) and the US Structured Products Association (SPA) in recognition of the importance of this work.

¹ The JAC is sponsored by multiple associations with an interest in structured products. The members of the JAC comprise most of the major firms (both financial institutions and law firms) involved in the creation and, to some extent, distribution of structured securities which are distributed to retail investors.

² Since 2007, the JAC has been an active participant in the European Commission's initiative on Packaged Retail Investment Products and has also contributed to regulatory initiatives by - and engaged with - regulators globally, including the International Organization of Securities Organization (IOSCO), the Australian Securities & Investments Commission, the China Banking Regulatory Commission, the Hong Kong Monetary Authority, the Hong Kong Securities and Futures Commission, the Italian CONSOB, the Securities Commission in Malaysia, the Monetary Authority of Singapore, the Taiwan Financial Services Roundtable and the UK Financial Services Authority.

Although the Principles are non-binding (being intended primarily to help inform firms' thinking), the events of recent years have served only to increase their relevance. **As highlighted above, much of their conceptual rationale foreshadowed the themes of recent regulatory reform in this area.**

Such themes have a commonality across jurisdictions:

- first, there is a focus on the **interactions between individual investors and distributors** – on ensuring that conflicts of interest of distributors and providers are managed, that the risk of misselling is mitigated and that products are suitable for the specific needs of a particular investor.
- secondly, there is a focus on greater **pre-sale disclosure** – on reducing the asymmetry of information that exists between the provider/distributor on the one hand and the investor on the other, and on ensuring that investors receive information that is readily understandable and can be compared with other products in the market.
- finally, there is an increasing recognition that certain products might not be appropriate for certain target audiences and that some form of regulatory **product intervention** may be justifiable in those instances.

Such themes are consistent with those that underpin the Principles and their merit is fully recognised and endorsed by the JAC. For example, DI Principle 1 emphasises that disclosure documentation should enable investors to evaluate the investment from a risk/reward perspective and that distributors responsible for the creation of marketing materials should ensure that such marketing materials are appropriately tailored to the knowledge and sophistication of individual investors in the target market. DI Principles 3 and 4 stress the importance of full disclosure of fees and commissions payable to the distributor and the importance of distributors identifying potential conflicts and how to mitigate, manage or disclose such conflicts. DI Principle 6 holds that distributors need to assess whether products are generally appropriate for their intended target market and DI Principle 8 looks at the importance of assessing the suitability of a product for a particular investor.

The PD Principles take account of the many different routes by which investment exposures are mediated to customers and the various roles played by financial institutions in such process (whether in the design of an index, structuring an investment product, arranging for its issue, managing the portfolio of assets associated with it, assisting a person to acquire it or advising a person on whether to do so). The PD Principles aim to ensure a clear allocation of roles and responsibility between providers and distributors.

Through the application of the Principles, the JAC aims to support the following consumer outcomes:

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

Given the above, the JAC strongly encourages providers and distributors to consider how best to reflect the Principles in their policies and procedures, and believes that the adoption of the Principles greatly assists in allowing investors to confidently access good quality and appropriate investment products. In

addition, adoption of the Principles serves a public policy interest in that it mitigates potential damage to investor protection from different or divergent national or regional approaches on these issues. This will be of ever increasing importance as markets continue to globalise and investors of all levels of sophistication and capability seek investment opportunities both in their home jurisdictions and beyond.

PARTICIPATING ASSOCIATIONS



Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 members institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

ISDA is listed on the EU Register of Interest Representatives, registration number: 46643241096-93.



ICMA represents financial institutions active in the international capital market worldwide. ICMA's members are located in 47 countries, including all the world's main financial centres. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years, providing the framework of rules governing market practice which facilitate the orderly functioning of the market. ICMA actively promotes the efficiency and cost effectiveness of the capital markets by bringing together market participants including regulatory authorities and governments. See: www.icmagroup.org

ICMA is listed on the EU Register of Interest Representatives, registration number 0223480577-59.



AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan- EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1st November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association.

AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA) and is an affiliate of the US Securities Industry

and Financial Markets Association (SIFMA) and the Asian Securities Industry and Financial Markets Association (ASIFMA). For more information, visit the AFME website, www.AFME.eu.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76



The voice of banking
& financial services

The British Bankers' Association (BBA) is the leading association for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of UK and international banking issues. All the major banking players headquartered in the UK are members of the association, as are the large international European Union banks with operations in the UK, the US banks operating in the UK and many other financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit-taking and other retail/commercial banking activities.



ASSOSIM (Associazione Italiana Intermediari Mobiliari) is the Italian Association of Financial Intermediaries, which represents the majority of financial intermediaries acting in the Italian Markets. ASSOSIM has nearly 80 members represented by banks, investment firms, branches of foreign brokerage houses, active in the Investment Services Industry, mostly in primary and secondary markets of equities, bonds and derivatives, for some 82% of the total trading volume.

ASSOSIM is listed on the EU Register of Interest Representatives, registration number 48038551498-21.



The Futures and Options Association (FOA) is the industry association for some 170 international firms and institutions that engage in the carrying on of derivatives business, particularly in relation to exchange traded transactions. The FOA's membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options section.

FOA is listed on the EU Register of Interest Representatives, registration number 2992254367-88.



The Securities Industry and Financial Markets Association 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.



The Asia Securities Industry & Financial Markets Association (ASIFMA) is an independent association whose mission is to promote the development of liquid, efficient and transparent capital markets in Asia and facilitate their orderly integration into the global financial system.

Association priorities are driven by the active participation of over 40 member companies, including global and regional banks, securities dealers, brokers, asset managers, credit rating agencies, law firms, trading and analytic platforms, and clearance and settlement providers involved in Asian capital markets.

ASIFMA is located in Hong Kong and works closely with global alliance partners: the Global Financial Markets Association (GFMA), the Securities Industry and Financial Markets Association (SIFMA) and the Association for Financial Markets in Europe (AFME).



The Institute of International Finance, Inc. (IIF), is the world's only global association of financial institutions. Created in 1983 in response to the international debt crisis, the IIF has evolved to meet the changing needs of the financial community. Members include most of the world's largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms. Among the Institute's Associate members are multinational corporations, trading companies, export credit agencies, and multilateral agencies. Approximately half of the Institute's members are European-based financial institutions, and representation from the leading financial institutions in emerging market countries is also increasing steadily. Today the Institute has more than 400 members headquartered in more than 70 countries.



The Structured Products Association (U.S.) is the trade association for the American structured investments industry. Comprised of nearly 12,000 professionals, the SPA advocates for the structured products investment class among regulators, media, advisors and investors. The SPA promotes investor education as a core mission of the industry.

ANNEX 1

PRINCIPLES FOR MANAGING THE PROVIDER-DISTRIBUTOR RELATIONSHIP (Published in July 2007)

A. Introduction

These PD 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 PD 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 PD 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 PD 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 associations¹. Furthermore, the associations issued the PD 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 PD 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 PD Principles do not, unless otherwise indicated, address the role of entities acting solely as issuer of a product.

The PD 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

¹ International Swaps and Derivatives Association (ISDA), International Capital Market Association (ICMA), previously London Investment Banking Association (LIBA) and European Securitisation Forum (ESF) (now Association for Financial Markets in Europe (AFME)), British Bankers' Association (BBA), Associazione Italiana Intermediari Mobiliari (ASSOSIM), Futures and Options Association (FOA), Securities Industry and Financial Markets Association (SIFMA), Asia Securities Industry and Financial Markets Association (ASIFMA), Institute of International Finance, Inc. (IIF) and US Structured Products Association (SPA).

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 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 PD Principles, as appropriate, to take account of such specific factors.

B. PD Principles

These PD Principles should be read in conjunction with the Introduction above, which contains important overarching comments on the nature and scope of the PD Principles. Moreover, the PD Principles are to be taken collectively, rather than viewing any one PD 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, eg, 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 PD 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 term-sheet 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.

ANNEX 2

PRINCIPLES FOR MANAGING THE DISTRIBUTOR-INDIVIDUAL INVESTOR RELATIONSHIP (Published in July 2008)

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 DI Principles in mind in their dealings with individual investors in structured products. These DI Principles complement and should be read in conjunction with the “Principles for Managing the Provider-Distributor Relationship” (or PD Principles) set out in Annex 1 hereto, which focus on the relationship between manufacturers and distributors. These principles apply to the relationship between the distributor and the individual investor.

Although these DI 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 PD Principles noted above (PD 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 DI 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 DI 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 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.

DI Principles

These DI 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 DI Principles. Moreover, the DI Principles are to be taken collectively, rather than viewing any one DI Principle in isolation from the others.

1. Product Transparency

The party who is primarily responsible for the creation of marketing materials¹, or is responsible for a prospectus, or other offering memorandum, should, to the extent permitted by applicable laws and regulations², 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'³ 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.

¹ The relationship between providers and distributors is specifically addressed in "Principles for Managing the Provider-Distributor Relationship" PD Principle 5 set out at Annex 1 hereto.

² 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.

³ "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 concerned⁴.

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 they affect 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

⁴ Insofar as a secondary market exists for the product. See DI Principle 7.

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.

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 price⁵, and other pertinent information.

⁵ Insofar as a secondary market exists for the product. See DI Principle 7.