



## **Suitability requirements with respect to the distribution of complex financial products. March 2013.**

IOSCO board has published, on the 21 of January, a final report (prepared by the Standing Committee 3 on Market Intermediaries) on the suitability requirements with respect to the distribution of complex financial products. This report sets out a range of principles relating to the distribution by intermediaries of complex financial products to retail and non-retail investors. Although complex financial products may not be necessarily more risky than standard financial instruments, they typically have terms, features and potential investment risks that may make it difficult to many customers, even non-retail customers, to appreciate fully.

The Joint Forum published on 2008 the report customer suitability in the retail sale of financial products and services which provided an overview of how supervisors and firms across the banking, securities and insurance sector address the risks posed by mis-selling of retail financial products, including related regulatory requirements; an important part of this work was to survey some 90 financial firms around the world as to how they deal with customer suitability, and manage the risks posed by mis-selling when distributing different types of complex instruments. IOSCO also carried out a consultation report on this matter on February 2012 and, taking into account the public comments received, issues the present report that is intended to complement the Joint Forum's work.

The report includes 9 key principles (with a heading and some means of implementation) covering the following areas:

Principle 1: Customers' classification.

Intermediaries should be required to adopt and apply appropriate policies and procedures to distinguish between retail and non-retail customers when distributing complex financial products. The classification of customers should be based on a reasonable assessment of the customer concerned, taking into account the complexity and riskiness of different products. The regulator should consider providing guidance to intermediaries in relation to customer classification. Possible criteria for the qualification of a customer as a retail or non-retail are suggested: the nature of the customer (regulated or unregulated entity, person acting in a business capacity or consumer), financial position, expertise and knowledge, and ability of customers to assess independently or with the assistance of an independent adviser the features of relevant products.

Although this principle states that customers have to be classified in retail and non-retail, the rest of principles do not set up either different suitability requirements or different intermediaries obligations depending on the customers classification. For this reason, the SEC has issued a statement concerning this report expressing its disagreement with its content because the report does not accurately reflect the relevant law in the USA and fails to properly respect the distinction between retail and institutional investors when determining the suitability requirements that should apply.

Principle 2: General duties irrespective of customer classification

Irrespective of the classification of a customer as retail or non-retail, intermediaries should be required to act

honestly, fairly and professionally and take reasonable steps to manage or mitigate conflicts of interest through implementing appropriate procedures in the distribution of complex financial products, and where there exists a potential risk of damage to the customer's interest, the intermediaries should, where appropriate, be required to clearly disclose the risk.

#### Principle 3: Disclosure requirements

Customers should receive or have access to material information to evaluate the features, costs and risks of the complex financial product. Any information communicated by intermediaries to their customers regarding a complex financial product should be communicated in a fair, comprehensible and balanced manner.

#### Principle 4: Protection of customers for non-advisory services

When an intermediary sells a complex financial product on an unsolicited basis (no management, advice or recommendation), the regulatory system should provide for adequate means to protect customers from associated risks.

#### Principles 5 and 6: Protection for advisory services (including portfolio management).

Whenever an intermediary recommends the purchase of a particular complex financial product, including where the intermediary advises or otherwise exercises investment management discretion, the intermediary should be required to take reasonable steps to ensure that recommendations, advice or decisions to trade on behalf of such customer are based upon a reasonable assessment that the structure and risk-reward profile of the financial product is consistent with such customer's experience, knowledge, investment objectives, risk appetite and capacity for loss. Intermediaries should keep written evidence of the information required by the regulator to be gathered from customers as part of the suitability determination of a product.

An intermediary should have sufficient information in order to have a reasonable basis for any recommendation, advice or exercise of investment discretion made to a customer in connection with the distribution of a complex financial product.

#### Principle 7: Compliance function and internal suitability policies and procedures.

Intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability requirements, including when developing or selecting new complex financial products for customers.

#### Principle 8: Incentives.

Intermediaries should be required to develop and apply appropriate incentive policies designed to ensure that only suitable complex financial products are recommended to customers.

#### Principle 9: Enforcement.

Regulators should supervise and examine intermediaries on a regular and ongoing basis to help ensure firm compliance with suitability and other customer protection requirements relating to the distribution of complex financial products. The competent authority should take enforcement actions, as appropriate. Regulators should consider the value of making enforcement actions public in order to protect customers and enhance market integrity.

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