Financial Services
Commission

Consultation Paper

IOSCO's Suitability Requirements with respect to the Distribution of Complex Financial Products

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Introduction

The International Organisation of Securities Commissions ("IOSCO") recently published its final report on 'Suitability Requirements with respect to the Distribution of Complex Financial Products'. This sets out principles relating to the distribution, by firms, of complex financial products.

IOSCO points, in particular, to the collapse of Lehman Brothers in 2008 as an event that highlighted the extent to which firms failed to assess the suitability of complex products for their clients.

As part of the work carried out by IOSCO, a total of 90 investment firms globally were surveyed regarding suitability and mis-selling risks. This work covered options, hedge funds, variable insurance products, direct participation programs/limited partnerships and real estate investment trusts.

The report sets out 9 principles relating to the distribution of complex products by firms and, for each of the principles, guidance on implementation.

Executive Summary

The purpose of IOSCO's principles is to "promote robust customer protection in connection with the distribution of complex financial products" by firms. The principles provide guidance on how the applicable suitability requirements should be implemented. The principles set out matters such as the establishment of policies for distinguishing between "retail" and "non-retail" customers; a firm's duties to its customers and the requirements to manage conflicts of interest; disclosure to, and protection of, customers; compliance processes, and compensation/remuneration policy parameters.

The principles apply in respect of both "retail" and "non-retail" customers. Whilst an exhaustive list of complex financial products is not provided, criteria which should help identify such products have been set out by IOSCO within the glossary.

The guidance dovetails with the requirements set out in the Financial Services (Markets in Financial Instruments) Act 2006 and the Financial Services (Markets in Financial Services) Regulations 2007 and the various MiFID guidance notes issued by the FSC. The guidance specifically focuses on the distribution of complex financial products and how suitability requirements and assessments should be carried out and applied in respect of these products. The FSC considers that this additional guidance would be useful for firms to be able to refer to when carrying out activities concerning complex financial products.

Subject to the concept of proportionality, the FSC is therefore proposing to issue a Guidance Note setting out Principles 1 to 8 of IOSCO's guidance on "Suitability Requirements with respect to the Distribution of Complex Financial Products".

Basis of consultation

The Consultation Paper focuses on principles 1 to 8 which relate to firms. Principle 9 relates to the role of the regulator and does not form part of this consultation paper.

Stakeholders are asked to consider the principles and guidance, as well as the ultimate objective of these principles. To note that the report observes that, as reflected in footnote no. 2 of the explanatory note to Principle 7, IOSCO already recognises that the compliance function should be proportionate to the scale and the type of the firm's business.

The full text of the principles is available via the following link –

http://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf

The Committee's consultative document and comments received during that process are also available via:

http://www.iosco.org/library/pubdocs/pdf/IOSCOPD373.pdf

Following the end of the consultation period, the FSC will consider the responses. The Paper will then be submitted to the Minister with Responsibility for Financial Services for his consideration. Where comments are received during the consultation process with which the FSC does not concur, these will also be advised to the Minister together with the FSC's reason for not accepting them.

All responses to the Consultation Paper will be made available for inspection, at Government's disposal, or on the FCS's website, unless there are particular reasons not to do so or confidential information needs to be protected.

Feedback on the consultation paper should be addressed to:

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to reach her by no later than close of business on 9 August 2013.

To view the FSC policy on public consultation, please see:

http://www.fsc.gi/fsc/consult.htm

The FSC is proposing to issue a Guidance Note setting out Principles 1 to 8 of IOSCO's guidance on suitability requirements with respect to the distribution of complex financial products. The principles are set out in full in this Consultation Paper.

Subject to the concept of proportionality, do stakeholders consider the guidance set out in the principles to be appropriate and useful?

IOSCO's Principles on Suitability Requirements with respect to the Distribution of Complex Financial Products

Glossary

For the purpose of these Principles, the relevant terms are defined as follows:

Complex financial products refer to financial products, whose terms, features and risks are not reasonably likely to be understood by a retail customer (as that term is defined in individual jurisdictions) because of their complex structure (as opposed to more traditional or plain vanilla investment instruments), and which are also difficult to value (i.e., their valuations require specific skills and/or systems, particularly when there is a very limited or no secondary market)[1]. The term generally includes, but is not necessarily limited to, structured instruments, credit linked notes, hybrid instruments, equity-linked instruments and instruments whose potential pay-off is linked to market parameters, asset-backed securities ("ABSs"), mortgage-backed securities ("MBSs"), collateralized debt securities, and other financial derivative instruments (including credit default swaps and covered warrants). The term does not include conventional equities, conventional bonds, plain vanilla unit trusts and mutual funds and exchange-traded standardized derivatives contracts. The list is intended to be illustrative and non-exhaustive. The above criteria should be taken into account when determining the level of complexity of a financial product.

Disclosure refers to any standard or requirement for an intermediary to disclose information to the customer that could be material to the investment decision (including information on risks and costs). In a sense, disclosure is intended to assist the customer in making his/her decision, but is distinct from the requirement for a firm to make a determination of whether a particular product is suitable for the customer.

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[1] Some of these complex financial products may be listed on an exchange, but nonetheless may be seldom traded and thus less liquid. Indeed, although the admission to trading of the product on an exchange may imply that it can be sold if desired, listing on an exchange cannot guarantee that there will not be large spreads or infrequent trading, thus making liquidation more difficult and time consuming. It should also be noted that that the valuation of complex financial products is done through the use of sophisticated models, which are generally not used by the retail public.

Distribution covers, in broad terms, the services of selling by the intermediary including marketing, selling, advising, recommending and, where relevant, managing discretionary accounts / individual portfolios, which results in holdings by customers of complex financial products.

Intermediary[2] means a firm in the business of managing individual portfolios, providing investment advice, executing orders on behalf of third parties, dealing in or distributing securities (including carrying derivatives positions)[3]. In jurisdictions where banks are permitted to provide investment services, this term includes banks to the extent they are providing such services.

Suitability requirements or **suitability** include any standard or requirement with which an intermediary is required or expected to comply in the distribution of financial products – including, as mentioned in the provision of investment advice, individual portfolio management, or in offering for sale both with and without providing a recommendation - to assess whether the product being sold matches the customer's financial situation and needs.[4] An assessment of the customer's financial situation and needs may include an assessment of the customer's investment knowledge, experience, investment objectives, risk tolerance (including risk of loss of capital), time horizon and/or capacity to make regular contributions and meet extra collateral requirements, and understanding of the product in question where appropriate. Suitability is intended to have a functional and all-encompassing meaning, in order to accommodate technical legal terms adopted in different jurisdictions. The intent is to cover, broadly, various requirements applicable to intermediaries in individual jurisdictions depending on the type of distribution (i.e. requirements applicable where there is investment advice, individual portfolio management, other investment services, etc.) and/or type of customer (e.g., "retail", "institutional", "sophisticated", and "professional", etc.) and/or type of complex financial product[5].

Classification of customers

Principle 1

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.

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[2] As stated in the IOSCO Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation (Oct. 2011), *"Market intermediaries generally include those who are in the business of managing individual portfolios, executing orders and dealing in, or distributing, securities".* According to the methodology, a jurisdiction may also choose to regulate as a market intermediary an entity that simply provides advice regarding the value of securities or the advisability of investing in, purchasing or selling securities. However, for purposes of this report, the term intermediary in the U.S. securities sector refers to registered swap dealers and broker-dealers, not investment advisers.

[3] The definition includes firms such as product providers who are also intermediaries, and which directly distribute complex financial products they produce. The term does not include issuers who are not intermediaries.

[4] However, Principles 4, 5 and 6 differentiate obligations of intermediaries for: (a) unsolicited sales (made without recommendations) or (b) sales made on the basis of a recommendation

[5] For instance, as far as European countries are concerned, reference to suitability should be read to include the concepts of suitability (for investment advice and portfolio management) and appropriateness (for other, non-advised, services) under Article 19 of Directive 2004/39/EC ("MiFID").

Means of implementation

1. The regulatory system should establish a process to distinguish between "retail" and "non-retail" customers, in light of the complexity and riskiness of the different products that an intermediary should take into consideration when assessing suitability.

2. Possible criteria for the qualification of a customer as a "retail" or "non-retail" customer include objective indicators based on:
    a. The nature of the customer (e.g., regulated vs. unregulated entity; person acting in a business capacity vs. consumer);
    b. financial position;
    c. expertise, experience and knowledge with respect to complex financial products (e.g., frequency and size of previous investments, relevant professional experience in the financial sector, and with complex financial products in particular; relevant experience with trading the asset class or complex financial product in question), and;
    d. ability of customers to assess independently or with the assistance of an independent adviser the value and features (including risks) of relevant products/transactions.

3. In some jurisdictions, certain suitability requirements are differentiated or waived (in whole or in part) depending on the customer classification. Nonetheless, caution should be exercised so as not to develop an overly broad presumption or definition of "non-retail" customer that could inappropriately limit the reach of suitability protections. Experience shows that presumptions may be inaccurate since they do not take into account the differences between entities, products and services. For example, during the recent financial crisis in some jurisdictions, some "non-retail" customers such as local authorities and municipalities appeared not to have understood the risks to which they were exposed, especially in the case of complex financial products. Accordingly, jurisdictions should consider whether additional protections are needed, particularly when public entities are involved.

4. Intermediaries should not automatically rely on a customer's request for "non-retail" customer status or, where relevant, on the triggering of a given threshold or size. In this event, intermediaries should be required to make their own assessments on the level of expertise and knowledge of the customer, giving reasonable assurance, in light of the nature of the transactions or services provided, that the customer is capable of exercising his or her own independent judgment on the investment decisions and understands the risks involved. Where any ambiguity exists, intermediaries should consider the customer "retail."

5. To the extent that the classification of customers is not determined by statute or regulation, the customer should be informed by the intermediary at the outset about what classification the intermediary has made and about the implications of such classification on the duties of the intermediary toward such customer.

6. Some jurisdictions may allow customers who qualify as "non-retail" customers to elect to be treated as "retail" customers. Moreover, intermediaries may be allowed to qualify and treat all customers as "retail" customers and afford them the corresponding higher level of protection.[6]

[6] Where permitted, some intermediaries may make the reasonable choice of treating all customers as "retail" because doing so may be more cost-effective than establishing separate categories for customers (e.g. "professional").

7. Where the intermediary has an on-going relationship with a customer (i.e., the customer continues to have an open account), the intermediary should be required to take reasonable steps to obtain updated or additional information from their customers on a periodic basis and whenever the intermediary becomes aware that the information it has about a particular customer may be inaccurate. Should the intermediary become aware that a customer no longer fulfils the criteria that made him eligible for classification as a "non-retail" customer, the intermediary should be required to take appropriate action with respect to any subsequent transactions.

General duties irrespective of customer classification

Principle 2

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.

Means of implementation

1. The overarching high-level principle to act honestly, fairly and professionally and the general duty of good conduct should apply irrespective of the customer classification, including in those jurisdictions where intermediaries are authorised to provide services to customers whose level of expertise may permit a "waiver", in whole or in part, of the protections offered by suitability rules.

2. This principle implies, for instance, that intermediaries should gather essential facts concerning every customer at the point of starting the business relationship and shall be responsible to deal fairly, protect the customer's assets they hold and not mislead him or her in their business dealings. Irrespective of any customer classification, intermediaries should be required to take reasonable steps to manage or mitigate conflicts of interest through implementing appropriate procedures and measures and, where there exists a potential risk of damage to the client's interest, the intermediary should be required to clearly disclose, where appropriate, the nature and/or source of conflict to the customer concerned before the provision of the service or the performance of the relevant transaction, so as to allow the customer to make an informed decision.

3. Subject to local regulatory requirements, when conflicts of interest are inherent to the transaction, such as a principal-to-principal relationship[7], the conflicts could be managed or mitigated though implementing appropriate procedures and measures and, where there exists a potential risk of damage to the client's interest, through further disclosures, such as identifying how the intermediary's interests may be adverse to its customer's interest. Intermediaries should also have policies and procedures to assess whether the customer has sufficient knowledge and expertise to evaluate the transaction and to evaluate any conflicts of interest that are inherent to the transaction.

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[7] While most securities regulators do not define a principal-to-principal transaction *per se*, such a transaction might be described as one where the trader executes the trade for its own account rather than the account of a client. Such a principal-to-principal transaction can be distinguished from a traditional intermediary relationship, i.e., where a broker acts as agent on behalf of another party (and earns a fee for doing so) and where such agent does not share in the economic risk of the transaction or participate in any benefit arising from the transaction.

Disclosure requirements[8]

Principle 3

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.

Means of implementation

1. Whenever intermediaries disclose, or make available to their customers, information regarding a complex financial product, whether as a matter of firm policy or regulatory mandate, reasonable care should be given to assist customers in making an informed investment decision, particularly in making them aware, before the purchase, of the specific (net of cost) risk-return profile of the complex financial product. Any information disclosed and prepared by the intermediary to the customer regarding a complex financial product should present a fair, clear, comprehensible and balanced picture regarding both the risks and potential benefits they pose, especially when the product's performance is sensitive to extreme scenarios. In particular, where an intermediary provides the customer with a scenario analysis, it should be based on reasonable assumptions and presented in a way that does not overstate the potential benefits and understate the risks of the complex financial product. This is because complex financial products may have features and pose investment risks that are difficult for many customers, even "non-retail" customers, to appreciate fully. In some instances, these products link high return rates to certain favourable, but unlikely, scenarios which may be used to create or enhance customer interest.

2. Intermediaries should not intentionally give their customers the false impression that complex financial products are comparable to non-complex plain-vanilla securities; rather customers should receive or have access to a description of the different components of the product and how these components interact and affect the risks.

3. Disclosure requirements should apply to the intermediary whenever it advises, or otherwise recommends, the purchase of a complex financial product. For example, the regulatory system should require that intermediaries recommending a complex financial product provide information to the retail customer on the features, specific risks, fair value, and other material aspects of the complex financial product. Such disclosure requirements should be tailored, as appropriate, to the type of customer.

4. Based on the classification of customers in some jurisdictions, there may be customers who do not fall within the scope of a "retail" customer, but may not have the level of skill or knowledge in order to be able to gather and assess the information needed on the purchase of a complex financial product. This could be the case where a customer meets certain income thresholds, but yet does not have the level of sophistication of an institutional investor. As noted below under Principle 5, where the intermediary recommends to a customer to

[8] Although the focus of this, as well as other principles, is on intermediaries, nothing in this section is meant to prevent regulators from imposing obligations on product providers and manufacturers with regard to disclosure, including, e.g., requiring product providers to provide offering materials for registered securities detailing product information.

purchase a complex financial product, the intermediary should consider the customer's investment experience, objectives and knowledge in relation to the complex financial products.

5. Customers should have reasonable access to information that allows them to identify costs and charges relating to the purchase of a complex financial product including, ideally, if practical and feasible, on an unbundled basis (i.e. a breakdown of the components of the total price).

6. When a liquid secondary market for a complex financial product does not exist, the only prices available may be from the intermediary that sold the customer the product. The intermediary should know and disclose ahead of time how these prices will be computed (using models, other markets for similar products, etc.) and what the price represents (mid-market theoretical value, re-purchase prices, etc.). The customer should have access to enough information to know that the product is illiquid, including information about the means and range of timing for disinvestment.[9]

7. Where practical and feasible, intermediaries should seek to provide customers with comparative information concerning appropriate alternative investment products, to the extent that such products are available.

8. Regulators should consider requiring a particular form of disclosure where products carry risks that may not be readily apparent to customers, particularly retail customers. In particular, regulators may require the employment of a simplified and user-friendly format summarising the key features of the complex financial product.

Protection of customers for non-advisory services

Principle 4

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.

Means of implementation

All regulatory systems should provide for, as appropriate, adequate minimum protections even where a customer purchases a complex financial product on an unsolicited basis.

1. Possible protections include:

    a. Assessing the level of knowledge and experience of the customer in the investment field relevant to the specific type of product or service (e.g., effectively prohibiting execution-only services in connection with the distribution of certain complex financial products);
    b. warning the customer that the transaction may not be appropriate or that it would be prudent to take investment advice;
    c. disclosing to the customer the features and specific risks associated with the transaction;

[9] For instance, the customer should be informed if the intermediary or another entity belonging to the same group is the only source of liquidity for the instrument.

d. imposing specific requirements with respect to transactions in certain complex financial products (e.g., index warrants, currency index warrants and options), including requiring written approval by firm managers to authorise the opening of an account to trade such products;
e. requiring the intermediary to assess whether it is advisable to offer a particular customer a service whereby they would gain access to a platform where they could trade complex financial products (e.g., retail trading platforms on contracts for difference, margin trading), and
f. prohibiting or restricting the distribution of certain categories of more risky or complex financial products to certain categories of customers, such as retail customers.

Suitability protections for advisory services (including portfolio management)

Principle 5

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.

1. **Means of implementation** In light of the greater reliance of customers on the recommendations and advice provided, or on the exercise of investment discretion by the intermediary, the provision of such advisory or discretionary services calls for stricter protections.

2. The regulatory system should require intermediaries to comply with suitability requirements, calibrated to the complexity and riskiness of the product and service and the level of sophistication of the customer. For example, suitability requirements may differ depending on whether the service being offered to the customer is advisory or discretionary investment management. If an intermediary's behaviour amounts to making a recommendation to a customer, it cannot avoid its suitability obligation by claiming that it has not made any recommendation to such customer.

3. Before recommending complex financial products to customers, intermediaries should gather and retain information from such customers relevant to the specific type of product or investment service.

4. Intermediaries should have a robust process to assess the profile of a customer for whom a suitability determination would apply on the basis of, among other things, the following factors relating to the customer:

   a. Investment objectives, including the length of time for which they wish to hold the investment. Age of the customer may be relevant for this factor;
   b. risk tolerance and relevant risk preferences, taking into account the purpose of the investment and the need for portfolio diversification;
   c. financial situation (e.g., the customer's other assets, income and tax liabilities) and general capacity to withstand losses of trading complex financial products;

d. investment experience and knowledge in relation to complex financial products, including the nature, volume and frequency of previous transactions and level of familiarity with relevant complex financial products and services. The customer's profession, former professional experience, and level of financial education may also be relevant;
e. liquidity needs;
f. any other relevant information the customer may disclose to the intermediary in connection with the recommendation.

5. Before recommending complex financial products to customers, intermediaries should themselves develop a thorough understanding of the features of the relevant product and its complexity and associated risks[10] taking into account, when providing individual portfolio management or advice, the composition of the customer's portfolio.

6. In particular, in the case of complex financial products, the intermediaries should perform their own analysis that considers:

   a. How the complex financial products are structured and priced;
   b. the nature and complexity of a product's pay-off and underlying components, if any;
   c. the relevant level of risk (with, if appropriate, a separate assessment of counterparty, liquidity and market risks);
   d. the experience and reputation of the issuers and product providers/manufacturers;
   e. any fees, charges or any other costs associated with the product;
   f. the level of liquidity;
   g. the lock-in periods and relevant termination conditions exit options and associated costs;
   h. how the product performs under abnormal or extreme conditions; and
   i. the nature of any guarantees[11].

7. Care should be given to the different components of a complex financial product in order to foster customer understanding of the risks associated with them. The complex financial products selected by intermediaries for distribution to their customers should in general meet the needs of the customer group at which the intermediary aims its services.

8. In making the recommendation, the intermediary should consider whether among the products it offers there are less complex, less costly alternative financial products that would be more suitable for the customer.

9. Any suitability obligations should apply both to the intermediary itself and to its representatives with regard to both required due diligence and any recommendation made to a customer. The sale staff of intermediaries should be trained to understand the features and risks associated with each complex financial product they recommend to meet suitability obligations.

10. In addition, when a liquid secondary market for the product does not exist, intermediaries should draw the attention of the customer to this fact and, where applicable, assess the fair value through methodologies, modelling and

[10] In some jurisdictions, this is referred to as "reasonable basis" suitability (meaning that the intermediary must determine that the product is at least suitable for someone).
[11] For illustrative purposes, an example of possible issues an intermediary should address when carrying out complex financial products' due diligence is provided for under Annex 1.

standards generally recognised and accepted in the market and consistent with those used by the intermediaries to value their own proprietary portfolios. Where a liquid secondary market does not exist, this might be communicated by, for example, explaining the costs and other consequences of terminating the product holding before its full term.

11. After assessing the characteristics of the customer and the product, intermediaries should determine whether the features and risks of the product are in fact suitable to the profile of that particular customer, including, but not limited to, whether the duration and liquidity of the proposed investment match the needs of the customer, taking into consideration his/her investment time horizon. In the case of a customer seeking products specifically for hedging purposes, intermediaries should check for consistency between the hedging needs of the customer and any products recommended.

12. Intermediaries should keep written evidence of the information required by the regulator to be gathered from customers as part of the suitability determination. In addition, regulators should require intermediaries to retain documentation to the extent that such written documentation is created, to evidence any inquiries and analysis they made when carrying out the product and customer due diligence.

13. Regulators should consider providing guidance to facilitate the discharge of the suitability responsibilities in the distribution of complex financial products as new and complex financial product continue to emerge.

Principle 6

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.

Means of implementation

1. Before an intermediary recommends the purchase of a particular complex financial product, or purchases the product for its customer as part of its provision of discretionary management services for the customer, the regulatory system should require the intermediary to obtain the information necessary to make a reasonably based recommendation concerning the suitability of the complex financial product to that particular customer.

2. Examples of possible approaches to implement this principle include, at a minimum, that where a customer fails to provide all information requested by the intermediary, the intermediary should be required to consider whether it has sufficient information to make a reasonably based recommendation. Where the intermediary determines that it does not have sufficient information, then it should be:

    a. Prohibited from making the recommendation or providing the service to the customer; or alternatively

    b. Where permitted to recommend the investment, it should be required to make clear that the recommendation is based upon limited information.

3. In either case, the intermediary should be required to act consistent with the best interests of the customer.[12]

4. Intermediaries should not recommend complex financial products they do not understand.

5. Another possible means to mitigate the risk of mis-selling would be to grant regulators, where there are substantial investor protection issues raised, the power to prohibit or restrict automatically the recommendation of certain categories of more risky or complex financial products to certain categories of customers, such as retail customers.

Compliance function and internal suitability policies and procedures

Principle 7

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.

Means of implementation

1. Intermediaries should be required to develop and maintain internal processes and procedures with a view to ensuring compliance with the suitability requirements, the management of conflicts of interests, the proper conduct of business and the fair treatment of all customers, including in the distribution of complex financial products. Effective internal reporting and communication of information at all relevant levels of the intermediary should be established.

2. More specifically, intermediaries should put in place and enforce written strategies, processes and controls in view to ensure that any financial products they intend to distribute, especially complex financial products, are suitable for the type of customers they intend to solicit.

3. When developing or selecting complex financial products for distribution, intermediaries should establish appropriate on-going internal processes for identifying, periodically reviewing and approving (or rejecting) the products in order to promote their compatibility with the characteristics and needs of the prospective customers they intend to target. This includes policies and procedures that support the design of products appropriate for particular customers. For instance, products should not be designed so as to hamper intentionally the ability of targeted customers to understand the risk-reward profile.

4. The compliance function should verify that the above internal processes and procedures are functioning properly.

Incentives

[12] The phrase "in accordance with the best interests of the client" suggest the application of a fiduciary standard. However, in some common law jurisdictions, certain intermediaries may be subject to the duty to act fairly, honestly and in good faith, while not being subject to a fiduciary standard of care. Moreover, it would not be expected that an intermediary would necessarily act consistent with the best interests of its counterparty, even though counterparties are considered customers for purposes of this report.

Principle 8

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

Means of implementation

1. Intermediary and staff compensation policies should be designed to ensure that only suitable complex financial products are recommended to the customer. Of particular concern is that the distribution of complex financial products by an intermediary can be more lucrative than selling "plain vanilla" securities, thereby creating selling pressures and incentives to encourage unsuitable transactions. Moreover, charges associated with the purchase of complex financial products may often be less apparent to the customers and harder to understand.

2. Senior management should be responsible for regularly reviewing incentive schemes and distribution practices by sales staff.

3. Intermediaries' remuneration structures and related sales staff incentive programs should not conflict with the duty to act honestly, fairly and professionally, and consistent with the best interests of the customer.[13] In particular, the intermediary should avoid any incentives to its sales staff to recommend a certain complex financial product when the intermediary could offer a different financial product that would better meet the customer's needs.

4. Regulators should consider taking steps to require disclosure of remuneration structures and policies (e.g., commissions received by the distributors from the product issuers) as a means to reduce the risks of financial incentives that could lead to unsuitable advice or recommendations.

[13] The phrase "in accordance with the best interests of the client" suggest the application of a fiduciary standard. However, in some common law jurisdictions, certain intermediaries may be subject to the duty to act fairly, honestly and in good faith, while not being subject to a fiduciary standard of care. Moreover, it would not be expected that an intermediary would necessarily act consistent with the best interests of its counterparty, even though counterparties are considered customers for purposes of this report.

Annex 1

Issues which may be considered by intermediaries when carrying out product due diligence in assessing suitability of a complex financial product:

- For whom is the product intended, e.g., limited or general retail distribution? If limited, how will the firm prevent distribution beyond the targeted customer group?

- What is the product's investment objective and how does the product improve upon the firm's current offerings? Are less complex, less costly, and/or less risky products available to accomplish the same investment objective(s)? Are the product's costs transparent to investors to allow independent cost comparison with other products?

- What key assumptions underlie the product's performance over time, e.g., market behaviour, interest rate changes, market volatility and market liquidity? What are the qualifications of the persons making the assumptions that underlie projections of the product's performance?

- How a complex financial product is structured and priced, its underlying components, its functions, and how it is described to the customer. In other words, does the complexity of the product impair understanding and transparency of the product? If so, what are the implications for the training requirements for the sales staff? Will the product require development or refinement of in-house training programs for sales personnel and their supervisors? In what respects?

- What promotional or sales materials will be used to market the product? What risks must be disclosed and how will those disclosures be made? What sorts of disclosures are needed to achieve a balanced promotion of the product to the targeted customer group?

- The relevant level of risk (with, if appropriate, a separate assessment of counterparty, liquidity and market risks). For example, what are the product's principal risk factors? Do they include any currency, legal, tax, market, or credit risks?

- The experience and reputation of the issuers;

- Any fees, charges or any other costs associated with the product;

- How liquid is the product? Will there be an active secondary market for the product, e.g., with liquidity providers? How will the fact that a particular product is illiquid impact its valuation during its life span? Will the product be marginable?

- The lock-in periods, exit options and associated costs; and

- The nature of any guarantees.

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Regulatory objectives and principles of good regulation – checklist

Which regulatory objectives are the proposals aimed to facilitate:?	
(a) To promote market confidence;	No – not applicable
(b) The reduction of systemic risk;	No - not applicable
(c) To promote public awareness;	No – not applicable
(d) The protection of the reputation of Gibraltar;	Yes – will ensure that firms apply the highest criteria in carrying out activities and afford customers most protection available thus contributing to the safeguarding of Gibraltar's reputation.
(e) The protection of consumers;	Yes – will ensure that appropriate suitability criteria is applied in respect of complex financial products
(f) The reduction of financial crime, including the funding of terrorism;	No – not applicable
Do the proposals accord with the following principles of good regulation?	
1. The need to use our resources in the most efficient, effective and economic way;	Not applicable.
2. The principle that the duty to manage a business falls upon the senior management of that business. The Directors of a licence holder, both executive and non-executive have ultimate responsibility for ensuring that the business is properly run and operates in accordance with regulatory requirements;	Yes –IOSCO emphasises that senior management should be responsible for regularly reviewing incentive schemes and distribution practices by sales staff.
3. The principle that a burden or restriction which is imposed upon authorised firms should be commensurate with the benefits expected to result from such action, so ensuring that the Authority is striking the right balance between achieving the statutory objectives and ensuring that the impact on those being regulated is not such as to be counterproductive;	Yes- The principles are intended to promote uniform standards on suitability as far as possible, in a way that would reduce regulatory and product arbitrage, mitigating any potential damage to investor protection whilst not been counter-productive.
4. The desirability of facilitating innovation in connection with regulated activities;	Not applicable.
5. The international character of financial services and markets and the desirability of maintaining the	Yes – compliance with International Standards such as IOSCO, helps to maintain the competitive position of

competitive position of Gibraltar; and	Gibraltar.
6. The need to consider the adverse effects of regulation on competition and consumer choice.	Yes – The guidelines focus on consumers being able to make an informed choice regarding complex products.
7. Does this match UK supervisory practices	The UK is also a member of IOSCO and it is expected that it will therefore also aim to comply with IOSCO standards.