



ICSA

INTERNATIONAL COUNCIL of SECURITIES ASSOCIATIONS

21 May 2012

Mohamed Ben Salem
General Secretariat
IOSCO
Calle Oquendo 12
28006 Madrid
Spain

Re: Public Comment on Suitability Requirements with respect to the Distribution of Complex Financial Products

Dear Mr. Ben Salem,

We are writing to you on behalf of the International Council of Securities Associations (ICSA), which is the global forum for trade associations and self-regulatory organizations that represent and/or regulate firms active in the securities industry.¹ ICSA Members support IOSCO's work to develop high-level global principles for suitability standards and we welcome the opportunity to comment on the Consultation Report (hereinafter referred to as the "Report") that was issued by IOSCO in February 2012. As with the other global principles that have been developed by IOSCO, principles for suitability standards will help to encourage greater consistency between the regulations in various jurisdictions.

Regarding the Principles as a whole, ICSA Members note that all of the Principles could be applied in a proportionate manner to all financial products rather than to just complex financial products. We are aware that the original mandate given to Standing Committee 3 was for the development of high level principles for suitability standards related only to complex financial

¹ ICSA is composed of trade associations and self-regulatory organizations that collectively represent and/or regulate the vast majority of the world's financial services firms on both a national and international basis. ICSA's objectives are: (1) to encourage the sound growth of the international securities markets by promoting harmonization in the procedures and regulation of those markets; and (2) to promote mutual understanding and the exchange of information among ICSA members. More information about ICSA is available at: www.icsa.bz

products. However, given the importance of this issue and IOSCO's initial work in the area of suitability, we suggest that IOSCO should give consideration to broadening the Principles so that they could be applied in a proportionate way to all financial products instead of just complex financial products.

ICSA Members welcome Principle 1 of the proposed Principles regarding the categorization of investors. We note, however, that the categorization is not actually used in the other proposed Principles, which we see as a lost opportunity. We suggest instead that the proposed Principles could adhere more closely to the framework already in place in a large number of jurisdictions where suitability obligations differ for retail and non-retail investors. Regulations in these jurisdictions uniformly apply a higher level of protection to retail investors. Although the differentiation in the treatment of retail versus non-retail investors is discussed in the accompanying text to some of the Principles, we suggest that the Principles should more explicitly incorporate the understanding that retail investors are in need of a higher level of protection than non-retail investors.

We also suggest that the Principles should distinguish between different types of non-retail investors depending on various objective criteria, such as the criteria that are set forth on page 15 of the Report. In light of the mis-selling that took place in some jurisdictions and in some financial products prior to the recent financial crisis, we acknowledge the regulatory desire to place ever more stringent suitability obligations on investment firms and to restrict the range of investment products to which some types of investors have access. ICSA Members recognize that appropriate levels of investor protection are absolutely necessary in order for financial markets to operate efficiently. However, excessive or inappropriate restrictions on investors' choices, particularly for those investors with the knowledge, experience and financial resources that would allow them to make their own investment decisions, would adversely impact the efficiency of financial markets and, as a result, have a negative effect on economic growth and job creation.

A finer distinction between different types of investors would help regulators to take into account the variations that actually exist among investors in terms of their level of financial knowledge,

experience and resources. For example, some non-retail investors may lack an appropriate level of sophistication and, in those cases, it may be appropriate to subject those particular investors to additional restrictions on their investment choices. Similarly, some retail investors, such as certain high net worth individuals, may have far higher levels of financial knowledge, experience and resources than other retail investors and, therefore, could be allowed access to a wider range of investment products.

ICSA Members also suggest that IOSCO's Principles for suitability standards should clearly state that regulators need to apply an appropriate balance between the responsibilities of investors and the obligations of investment firms when developing suitability standards for their jurisdictions. Efficient markets that serve the needs of investors as well as broader economic objectives depend on the principle that investors as well as financial intermediaries are responsible for their actions.

In closing, we would like to emphasize our support for the work that IOSCO has done in developing the draft Principles and welcome the opportunity to comment on them. IOSCO's work on suitability standards is extremely important in terms of strengthening the stability and integrity of financial markets on a national, regional and global basis. Please do not hesitate to contact us if you have any questions regarding the comments in this letter.

Sincerely,



Jong Soo Park, Chairman
International Council of
Securities Associations (ICSA)



Duncan Fairweather, Chairman
ICSA Standing Committee on
Regulatory Affairs

Specific Comments on the Proposed Recommendations:

1. 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 and services. The regulator should consider providing guidance to intermediaries in relation to customer classification.

Comment: ICSA Members support the proposed Principle 1 and suggest that it should be applied to all financial products and not just complex financial products. In addition, we suggest that Principle 1 should be amended so that it is clear that the classification of customers is based on objective criteria, such as those that are specified in the accompanying text to Principle 1. These include: (a) the nature of the customer; (b) the customer's financial status; (c) the customer's financial experience and knowledge; and (d) the customer's ability to assess independently the values and risk of the transaction. This is important since the term, "a reasonable assessment of the customer concerned", may be interpreted differently in different jurisdictions. Therefore, we suggest that the Principle should state explicitly that the "reasonable assessment" of the investor must be based on objective criteria, such as those specified in the accompanying text.

As noted in the cover letter, we further suggest that the Principle 1 or a separate Principle should acknowledge the differences that exist between different types of investors so that specific obligations could be developed for different categories of investors based upon certain objective criteria, such as their level of financial knowledge, experience, and resources.

In addition, there are some aspects of the accompanying text to Principle 1 which we believe need clarification. For example, the accompanying text to Principle 1 notes that:

Intermediaries should not automatically rely on the customer's demand for non-retail customer status or, where relevant, on the triggering of a given threshold or size. 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 own independent judgment on the investment decisions and understanding the risks involved.

We would like to point out that this language is not consistent with some of the regulations in some jurisdictions, such as the EU, where some investors can be classified as as non retail by nature, and their expertise or knowledge can be assumed.² (ICSA members agree that such assessment is necessary when a retail investor requests to be treated as a non-retail one;.

² This applies in the EU, for example, to regulated credit institutions, mutual funds and large companies that meet certain quantitative criteria.

However, we suggest that the upfront categorisation of non-retail investors should still be possible without conducting such an assessment.

The accompanying text to Principle 1 further states that:

A jurisdiction may allow customers who qualify as non-retail customers to demand to be treated as a retail customer. Moreover, intermediaries may be allowed to qualify and treat all customers as retail customers and afford them the corresponding higher level of protection. Should the intermediary, however, become aware that the 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. The intermediary should update the information about their customers on a periodic basis to keep it current.

We would like to point out first that this particular paragraph is confusing since the first two sentences refer to non-retail customers who are treated as retail customers, while the third sentence refers to the situation of a non-retail customer that is no longer eligible for that classification. We do not object to the first two sentences, but find their placement confusing.

Moreover, with regard to the third sentence requiring the intermediary to take appropriate action if a customer no longer fulfils the criteria that made him or her eligible for classification as a non-retail customer, we note that this sentence is not entirely consistent with some regulations, such as the EU's. ICSA members agree that financial intermediaries and their employees need to be aware of any indicators suggesting that an investor does not or no longer meets the requirements that would allow them to be classified as non-retail investors. However, in keeping with our earlier statement regarding the need to maintain an appropriate balance between the responsibilities of investors and the obligations of financial intermediaries, we suggest that the accompanying text to Principle 1 should also include a reference to the investors' responsibility to keep their intermediary informed of any change to their situation.

Finally, we note that some of the Principles refer explicitly to self-regulatory organizations (SROs) while others do not. Since SROs in many jurisdictions are responsible for setting suitability obligations for financial intermediaries, we suggest that the last sentence of Principle 1 should refer explicitly to both regulators and self-regulatory organizations.

2. 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 conflicts of interest that arise in the distribution of complex financial products, including through disclosure, where appropriate.

Comment: ICSA strongly supports Principle 2 and suggests that it should apply for all financial products and not just complex financial products.

3. Disclosure requirements

Principle 3: Investors should receive or have access to material information to evaluate the nature, costs and specific 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.

Comment: ICSA Members broadly support Principle 3 and suggest that it should be applied to all financial products and not just complex financial products. However, we are concerned about the lack of precision in the wording of Principle 3, specifically with reference to the word “costs”, as there are various ways to represent the costs of a financial product, particularly the cost of a complex financial product.

We agree that investors need to receive information about the costs of the services provided by a financial intermediary as well as the upfront cost of a financial product that the investor may purchase. If that is what IOSCO means by the word “cost” in Principle 3, we suggest that it would be useful to be more explicit. For example, the word “cost” could be deleted from the first sentence and a second sentence could be inserted specifying that investors should receive information from the financial intermediary which clearly sets out the fees that would be charged by the financial intermediary and any other associated costs that would be incurred if the investor were to purchase a recommended financial product and/or follow a recommended investment strategy.

We note that the second sentence of Principle 3 states that any information from intermediaries to their customers, “...should be communicated in a fair, comprehensible and balanced manner”. Although this is not a major issue, we suggest that the word “balanced” may be insufficiently precise and suggest that the term “non-misleading manner” could be used instead.

We are also concerned about one aspect of the accompanying text for Principle 3, which states that, “...where practical and feasible, intermediaries should seek to provide customers with comparative information concerning appropriate alternative investment products.” We suggest that this paragraph should be clarified since it could be construed as requiring that intermediaries evaluate all of the possible alternative investments available on the market that would be suitable for the specific client. Such a requirement could conflict with the business models of many firms, particularly those that do not offer third-party products. Also, it would be extremely difficult if not impossible for intermediaries to comply with this requirement given the difficulty of defining what constitutes an “alternative” investment (since this depends on the criteria considered like the pay-out, risks, asset class, product type, etc.). The requirement could mean that the financial intermediary would have to evaluate an extremely large number of very different products. Therefore, compliance with such a requirement would substantially increase the costs of advisory services for financial intermediaries and their clients, and may make such services prohibitively expensive for many investors, particularly retail investors.

4. Protection of customers for non-advisory services

Principle 4: Even when an intermediary sells to a customer 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.

Comment: ICSA members broadly support Principle 4 and suggest that it should be applied to all financial products and not just complex financial products.

As IOSCO is aware, regulators already have regulations in place in different jurisdictions to protect investors in non-advised or execution only transactions involving complex financial products. These include: (1) limitations or the outright prohibition on the sale of certain financial products on a non-advised basis to an investor; (2) limitations or the outright prohibition on the sale of certain financial products to retail investors; and/or (3) the requirement that financial intermediaries obtain additional information from investors so that they can make a “reasonable determination” regarding whether or not certain types of transactions should be restricted for certain categories of investors. The Report explicitly refers to the third type of regulation in the accompanying text to Principle 4 and refers to the first and second forms of regulation in the accompanying text for Principle 6.³ We are aware that many jurisdictions have moved to ban the sale of complex financial products to retail investors in particular. Therefore, we suggest that it may be useful for IOSCO to explicitly reference all three types of regulatory approaches in the accompanying text to Principle 4.

5. Suitability protections for advisory services

Principle 5: Whenever an intermediary recommends to a customer that it purchase 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.

Comment: ICSA Members generally support this Principle and suggest that it should be applied to all financial products and not just complex financial products. We also suggest that Principle 5 could be developed further so that there is a differentiation between the suitability requirements needed for retail investors, who deserve the highest level of protection, and the suitability requirements needed for non-retail investors, who have a higher degree of understanding about the financial products in question and therefore would not need as high a degree of protection. Specifically, we suggest that suitability requirements specified in Principle 5 should be in place

³ As is noted on page 29 of the Report, suitability obligations for non-advised services vary widely between jurisdictions, and in a number of jurisdictions there are no such obligations even for retail investors. In other jurisdictions suitability requirements for non-advised services exist but are far less onerous than those for advised services. Specifically, as the Report notes, there are no suitability requirements for non-advised services in Canada and the U.S., for example, while in the EU the far lighter appropriateness requirements are in place for non-advised services as opposed to the suitability requirement.

for all financial products offered to retail customers. In that case, we suggest that IOSCO also include language in Principle 5 specifying that financial intermediaries need to exercise stronger or heightened due diligence when recommending or selling complex financial products to retail investors.

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.

Comment: ICSA Members agree with this Principle in general and suggest that it should be applied to all financial products and not just complex financial products.

However, we find the language in Principle 6 to be confusing as it is not clear what type of information an intermediary should have. In order to eliminate this ambiguity, we suggest that Principle 6 should state explicitly that the financial intermediary must have sufficient information about the client based on objective criteria, such as that set out for Principle 1, as well as the financial product.

In this context, we also suggest that the accompanying text to Principle 6 should clarify that those financial market professionals that interface directly with investors must clearly understand the products and investment strategies that they recommend to their customers. This is implicit in the Principle itself, but could also be made explicit in the accompanying text.

The accompanying text to Principle 6 states that the goal of this specific Principle is to, "...reduce inducements to purchase a financial product where the customer neither understands the product nor is capable of assuming the financial risk".⁴ As noted below in our comment on Principle 8, we suggest that this idea could be stated in a more positive manner. For example, the accompanying text to Principle 6 could specify instead that financial intermediaries should have in place procedures intended to ensure that their sales force only recommends financial products to investors for whom, based on the objective criteria provided elsewhere in the Principles, such products are suitable.⁵

We also highlight footnote 29 which is attached to the explanatory text for Principle 6 and which states that,

The words "in the best interest of the customer" should not be interpreted to suggest the application of a fiduciary standard in all instances. In some common law jurisdictions, certain intermediaries may be subject to the duty to act fairly, honestly and in good faith, while not being technically subject to a fiduciary standard of care.⁶

As IOSCO is aware, this is an important issue in some jurisdictions and therefore we suggest that the footnote should be moved to the explanatory text.

⁴ Ibid., page. 22.

⁶ Ibid., page 22.

6. 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 obligations, including when developing or selecting new complex financial products for customers.

Comment: ICSA members agree with Principle 7 and suggest that it should be applied to all financial products in a proportionate manner and not just to complex financial products. We also note, however, that the Principle as written is not completely clear. We understand that the Principle is referring to the obligation of the financial intermediaries that design complex financial products as well as the financial intermediaries that sell complex financial products to have appropriate internal policies and procedures in place so that they are in compliance with their suitability obligations. However, we find that this Principle is confusing as written and suggest that it could be written in a more straightforward manner. For example, it may be useful for IOSCO to specify that financial intermediaries should give reasonable consideration to the target market in the design and distribution of all financial products including complex financial products.

7. Incentives

Principle 8: Intermediaries should be required to develop and apply proper policies that seek to eliminate any incentives for staff to recommend unsuitable complex financial products.

Comment: ICSA members agree with Principle 8 and suggest that it should be applied to all financial products and not just complex financial products. In addition, ICSA Members also suggest that Principle 8 should be expressed in a more positive manner since, as currently written, it seems to imply that intermediaries would likely to have in place incentives for staff to recommend unsuitable financial products to their customers unless they were expressly prohibited from doing so. For example, Principle 8 could be written to specify that financial intermediaries should develop and apply policies designed to ensure that only appropriate and suitable financial products are recommended.

8. Enforcement

Principle 9: Regulators and self-regulatory organizations 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. Enforcement actions should be taken by the competent authority, as appropriate. Regulators should consider the value of making enforcement actions public in order to protect investors and enhance market integrity.

Comment: ICSA Members agree with Principle 9 and suggest that it should be applied to all financial products and not just complex financial products. In addition, we suggest that Principle 9 also include a reference to self-regulatory organizations at the beginning of the last line, in addition to the existing reference in the first line.