



ALFI COMMENTS AND RESPONSES TO THE IOSCO CONSULTATION REPORT ON SUITABILITY REQUIREMENTS WITH RESPECT TO THE DISTRIBUTION OF COMPLEX FINANCIAL PRODUCTS

General Introduction

ALFI is the representative body of the 2.2 trillion Euro Luxembourg fund industry. It counts among its members not only investment funds but also a large variety of service providers of the financial sector. There are 3,847 undertakings for collective investment in Luxembourg, of which 2,430 are multiple compartment structures containing 11,917 compartments. With the 1,417 single-compartment UCIs, there are a total of 13,334 active compartments or sub-funds based in Luxembourg.

According to November 2011 EFAMA figures, Luxembourg's fund industry holds a market share of 31.2% of the European Union UCITS fund industry, and according to 2009 Lipper Hindsight data, 76.2% of UCITS that are engaged in cross-border business are domiciled in Luxembourg. As one of the main gateways to the European Union and global markets, Luxembourg is the largest cross-border fund centre in the European Union and, indeed, in the world.

ALFI welcomes IOSCO's initiative to consult on suitability requirements with respect to the distribution of complex financial products. As a general comment, ALFI would like to underline that one should make a clear distinction between the use of complex techniques or strategies and the risks that may be inherent to complexity as such. Financial products using complex investment techniques are not necessarily unsuitable for retail clients, provided that risks associated with such investment techniques are appropriately managed and disclosed.

We also recommend taking into account the fact that investment firms can only rely on the information provided by their clients and that it is those clients' responsibility to give true and reliable information as well as to communicate any relevant changes in their personal situation. Overall we think that current rules are adequate and that any new regulation in this regard should be able to demonstrate real value-added to the suitability process and not constitute a mere additional administrative burden. Finally we are of the view that it is paramount that a level-playing field be achieved between the various financial products with regard to suitability assessment obligations. We therefore recommend that IOSCO encourages its members to do more work to make all investment products comparable, at least on fundamental elements required by investors such as returns, risk and cost.

Preliminary comment – Glossary - Definition of complex financial products

IOSCO defines complex financial products as:

“... products, whose terms and features are not likely to be understood by an average retail customer (as opposed to more traditional or plain vanilla investment instruments), where these products have a complex structure, are difficult to value (so that their valuations require specific skills and/or systems) and/or have a very limited or no secondary market (and are therefore potentially illiquid). 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), collateralised debt securities, and other financial derivative instruments (including credit default swaps and covered warrants). The term does not include conventional equities, conventional bonds and exchange-traded standardised derivatives contracts. The said list is intended to be illustrative and non-exhaustive. The above criteria are proposed to be taken into account when determining the level of complexity of a financial product.”

The definition above concentrates on the understanding of complex structures and does not take into account the potential risk linked with a product. It ignores the fact that non-complex financial instruments, such as conventional equities, may include a higher risk of loss for the client than products which include a more complex structure but a lower risk of financial loss, such as products with a guaranteed pay-off, or so called 'guarantee funds'. This may lead to the incorrect view that products using less complex techniques and instruments are risk free, including potentially from an investment performance perspective. Therefore we believe it is essential to make a clear distinction between the use of complex, innovative techniques and strategies on the one hand, and the risks that may be associated with complexity, if any, on the other hand.

For instance, UCITS may use derivatives which aim at acquiring exposure to certain markets or sectors not easily accessible to retail investors, reducing investment costs and mitigating or eliminating specific risks. The use of derivatives combined with innovative investment strategies may mitigate market risk and reduce NAV volatility. Retail investors should not be denied access to these products and the benefits they may bring.

We believe that investor protection could be more effectively achieved by having regulations focusing on mitigating risk potentially deriving from the use of complex financial instruments rather than trying to define such complexity.

Comments on Section 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.

In ALFI's view retail clients should not automatically be prevented from investing in certain complex financial products as long as the potential risks which may arise from such products are assessed, either through the intermediary or by the client's own assessment – as being compliant to the investment objectives, the risk tolerance, the

financial situation and the investment experience and knowledge of the client and are disclosed in a proper and sufficient way.

If these basic principles, already laid down in the MiFID, are established as a standard for the distribution of all financial products, the aim of protecting retail clients from unnecessary risks would be achieved, this would be preferable to not allowing the recommendation, or giving of advice, for certain products.

Therefore we think that even retail clients who by their own choice decide to invest in a complex product should be allowed to do so, as long as the risks which may arise out of the product are disclosed sufficiently.

It must be noted that it is ultimately up to the customer to provide (obviously on the basis of a sensible questionnaire provided by the investment firm) the relevant information. ALFI is of the view that the investor has to take full responsibility of providing accurate information – investment firms are unable to verify that all information provided by the client is correct. Requesting documented evidence of income, assets and liabilities from clients who are seeking to purchase investments is viewed by many clients as an unreasonable violation of their privacy. It must be left to the reasonable discretion of the investment firm whether it regards the information it has received as sufficient to form a basis for the customer classification. The same applies when ensuring that the questions and investment products discussed are understood. When asking clients what types of instruments they are familiar with, investment firms must be able to place reliance on responses given by their clients. However, ALFI wishes to make clear that investment firms do need to be able to protect themselves against the possibility of investors who have incurred a loss asserting, at a future point in time, (potentially wilfully) that they answered certain questions incorrectly. There needs to be a reasonable balance between the extent to which an investment firm can be expected to ensure reliability of the information collected and the exposure an investment firm can face with clients exploiting such “loopholes” in the suitability investor protection mechanism in case of unsuccessful investment.

Moreover we do not see a necessity to question a client’s demand for non-retail customer status if the investment firm comes to the conclusion that the client has enough experience and can assess the value and risks of the product involved. Similarly it is the client’s responsibility to inform the intermediary about relevant changes in his personal situation that may require the investment firm to update their assessment.

Comments on section 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.

ALFI agrees with the principle that 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, irrespective of the customer classification. This is a principle already contained in MiFID.

It should also be made clear that customers also have a responsibility to act honestly and fairly in their dealings with intermediaries, especially in the provision of information upon which an intermediary relies to provide a client classification of to provide investment advice.

Comments on section 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.

ALFI agrees with the principle that investors should receive or have access to material information to evaluate the nature, costs and specific risks of the complex financial product. One must underline that the harmonized and standardized disclosure of the features, risks, costs etc. of the UCITS product by way of the KID (Commission Regulation (EU) No 583/2010, and in particular CESR/10-1318: Guidelines on Selection and presentation of performance scenarios in the Key Investor Information for structured UCITS) certainly is a very useful and sufficient step to ensure appropriate disclosure and contains most of the elements mentioned in IOSCO's consultation report. The KID may be longer than a simple 2 page document in the case of structured UCITS. Indeed this document is supposed to be clear enough for investors and ensures the provision of the appropriate information to them in a timely way. It must be underlined that the "PRIIPS" proposal is largely based on this model. MiFID also contains disclosure rules regarding the possible sources of conflicts of interest, the nature and risks association with the investment services offered to investors, which do apply to the sale of non-UCITS as well.

Comments on section 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.

ALFI takes the view that clients who by their own choice decide to invest in a product which might include a risk, should be allowed to do so, as long as the risks which may arise out of the product are disclosed sufficiently. That is the case from our point of view especially with regards to UCITS as the UCITS directive, as mentioned above regarding question 1 provides a harmonised framework for ensuring adequate information on the characteristics of the product and appropriate risk disclosure in the form of the KID, while non-UCITS do often not enjoy a comparable disclosure regime.

ALFI therefore welcomes the suggestion to establish comparable standards for all financial products, as is foreseen in the EU with the "PRIIPS" directive proposal. One must note that MiFID principles do only apply in the EU. Other types of classifications exist in other parts of the world and may not always be compatible with the European one. Some type of common understanding on the criteria used for classification purposes on international level could therefore be helpful.

Apart from any disclosure requirements the freedom for a customer to buy a product even if the intermediary has come to the conclusion that it is not a suitable product for this investor should remain. Clearly in such a situation the intermediary should document their position and advise the investor in writing that the purchase has been made against the advice given by the intermediary. However in such circumstances an intermediary should be able to execute a transaction upon order of the investor without incurring any liability.

Comments on section 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.

ALFI agrees with the principle that whenever an intermediary makes a recommendation to purchase a particular complex financial product it should be required to take reasonable steps to ensure that his recommendation is based upon a reasonable assessments of the customer's experience, knowledge, investment objectives, risk appetite and capacity for loss. Such principle is already contained in the MiFID. However it must be noted that there are also some practical difficulties related to the information to be gathered according to the draft guidelines. Investment advisers have noticed that in general clients are not willing to disclose information such as total income, assets and regular financial commitments. As a result, those clients would prefer investment firms that ask the "least intrusive" questions, resulting in a distortion of competition. ALFI is of the view that such assessment should be made at the point of sale of the product but should not be required on a continuous basis from the intermediary. An update on a regular basis should be acceptable. In the meantime it should be up to the investor to inform the intermediary of any event that could impact the assessment.

Finally it goes without saying that proper recommendations can only be provided if the intermediary understands the product it recommends to invest in.

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.

We generally agree with this principle. As regards the collection of information from the investor we refer to our comments above (section 1). We however recommend to reword IOSCO's goal which has been pointed out in the proposed recommendations on page 22. There it says:

"Before the intermediary recommends or advises a customer that it should invest in a particular financial product or purchases the product in the provision of discretionary management services to such customer, the regulatory system should require the intermediary to obtain the information necessary to make a reasonably based recommendation concerning the financial product. The goal is to reduce inducements to purchase a financial product where the customer neither understands the product, nor is capable of assuming the financial risks". In order to avoid any misunderstanding with regard to 'inducements' or 'incentives' an investment firm may receive in compliance with the MiFID and the UCITS Directive, we would recommend that IOSCO amends the sentence as follows: "The goal is to prevent the customer from purchasing a financial product where he neither understands the product, nor is capable of assuming the financial risks".

Finally, it must be noted that any advice should be provided in full independence by the intermediary. This is a general principle that derives from the global obligation to act in the best interests of the investor.

Comments on section 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.

ALFI agrees with the principle that intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability obligations. We welcome the suggestion that such compliance function be proportionate to the scale and type of these intermediaries' business. We however propose that, with respect to the requirement of putting in place and enforcing written strategies to ensure that financial products are suitable for the type of customers they intend to solicit, intermediaries should be allowed to rely on the product suitability classification, a product provider provides on the basis of a standard clients classification scheme.

Comments on section 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.

ALFI agrees with the principle not to encourage the recommendation of complex products by higher incentives. It must be underlined that the UCITS Directive already contains a lot of disclosure requirements in this regard.

Comments on section 8 – Enforcement

Principle 9: Regulators and self-regulatory organizations should supervise and examine intermediaries on a regular and on-going 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.

ALFI agrees with the suggestions made.

As underlined in footnote 32, IOSCO's report does not address the liability of intermediaries to their customers in cases of violations of suitability obligations or other investor protection issues. However we would like to state that we agree with the remark in this footnote that systems recognizing civil liability of intermediaries may provide a meaningful incentive for intermediaries to discharge properly their suitability obligations. The applicability of existing national civil law principles to the sale of financial products has not given rise to major issues up to now in our view.