

## International Organization of Securities Commissions Releases Consultation Report on Regulation of Retail Structured Products

April 30, 2013

A working group<sup>1</sup> of the International Organization of Securities Commissions (IOSCO), the Madrid-based international policy forum for securities regulators from more than 115 jurisdictions, published for public comment a [consultation report](#) on April 18, 2013. The working group proposes that the regulatory challenges posed by retail structured products, particularly in the area of investor protection, need to be addressed not only by requiring proper suitability determinations by distributors at the time of sale, but also by focusing on structurers and issuers earlier in the process of product design. The consultation report analyzes trends along the entire “value-chain” of the retail structured product market, from design and issuance of the products to marketing, distribution and post-sale practices, and proposes a “Regulatory Toolkit” setting out regulatory options that IOSCO members may find useful in addressing concerns with retail structured products.

Formed by IOSCO in February 2012, the working group first surveyed the IOSCO members and asked them to describe the regulatory challenges observed in their jurisdictions and to offer their views on “best practice” for dealing with these challenges. The consultation report was based on the results of the survey provided by 26 IOSCO members<sup>2</sup> and the feedback from an industry round table held in early November 2012 in London.

### Survey Results

The survey highlighted some of the market events and concerns that have prompted the regulators to act, including mis-selling of retail structured products and information asymmetries, where those issuing and selling the products have more information about the product than retail investors. The results of the survey also identified a broad range of regulatory responses to retail structured products. Most respondents reported having disclosure and marketing regulatory standards, requiring suitability assessments and having product intervention power of some kind, while fewer respondents reported having collateral and margin requirements or regulatory capital requirements set up to limit counterparty risk. Sixteen out of twenty-six respondents reported that at the time of the survey they were contemplating changes to the existing regulatory framework applicable to retail structured products.

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<sup>1</sup> The Working Group on Retail Structured Products of the Task Force on Unregulated Markets and Products (TFUMP)

<sup>2</sup> Respondents to the survey include Australia, Austria, Belgium, Brazil, Finland, France, Germany, Greece, Hong Kong, Hungary, Iceland, India, Italy, Japan, Lithuania, Maldives, Malta, Mexico, Portugal, Quebec, Slovenia, South Africa, Spain, Switzerland, The Netherlands and the United Kingdom. During 2012, the Staff in the Division of Corporation Finance at the U.S. Securities and Exchange Commission (SEC) also issued a [comment letter](#) in April 2012 to certain issuers of structured notes in an effort to improve disclosures with respect to future structured note offerings. FINRA, the self-regulatory organization for U.S. broker-dealers, also issued guidance concerning the heightened supervision of complex products (including structured products) in [Regulatory Notice 12-03](#) and guidance concerning its suitability rule covering structured products in [Regulatory Notice 12-55](#).

## Regulatory Toolkit

The “Regulatory Toolkit” proposed by the consultation report sets out regulatory options that IOSCO members may find useful in addressing concerns with retail structured products. No regulatory action is mandated by the Toolkit, and it is recognized that not every proposal would work for all IOSCO members. According to the consultation report, the use of any regulatory tools discussed in the consultation report “within any specific jurisdiction will involve the consideration by that jurisdiction’s authorities of complicated questions of the degree of individual responsibility considered appropriate for the jurisdiction and the institutional capabilities of the relevant regulator.” Regulators may choose to implement some, all, or none of the suggested tools in their jurisdictions.

The Toolkit is organized along the value-chain, covering product design and issuance, disclosure and marketing, distribution and post-sale practices. A number of the Toolkit proposals are highlighted below.

- *Regulatory Arbitrage* – Regulators could consider coordinating, discussing or aligning their regulatory activities and rules on retail structured products with other agencies outside and/or within their jurisdictions to reduce any inter- or intra- jurisdictional regulatory arbitrage. The issue of inter-jurisdictional arbitrage is especially important for an integrated market, such as the European Union, where retail structured products may be easily sold across borders. Regulators could also focus on intra-jurisdictional regulation to prevent products being offered via different product wrappers without the same degree of protection across instruments.
- *Investor Identification and Assessment* – Regulators could consider requiring or encouraging product issuers to identify the investor type that they intend to focus on for a structured product and to take steps to highlight for distributors the target investors to reduce potential mis-selling. This proposal recognizes that suitability is not just an issue for distributors. If an issuer has a clear sense of the target investors, it may be more likely to design a distribution process to ensure the product ends up with the suitable investors.
- *Financial Modeling* – Regulators could consider requiring issuers to construct financial models that allow the performance of a structured product to be simulated using historical or hypothetical future market movements. Financial modeling could be used to assist issuers’ internal product approval by “stress-testing” the product’s performance in different scenarios and to improve product disclosure to investors. Modeling may help address concerns about information asymmetries and investor understanding of the product as long as investors do not place too much reliance on it.
- *Short-form Summary Disclosure* – Regulators could consider requiring issuers to provide short-form summary disclosure, such as factsheets, separately or as a part of the offering documents to be made available to investors. The summary disclosure may also include comparisons with benchmarks and other similar products. This summary disclosure is similar in concept to the European key information document (KID).
- *Costs and Fees* – Regulators could consider requiring full disclosure of explicit and implicit fees and charges for each of the product components as well as the product itself to help investors compare different products.

- *Use of Fair Value Assessment* – Regulators could consider requiring issuers to disclose to investors the estimated fair value of a retail structured product upon issuance to help investors compare this value with the price paid and the value of the product in the secondary market.<sup>3</sup>
- *Backtesting* – Regulators could consider whether to require disclosure of any backtesting of a retail structured product based on its mathematical formula as long as such disclosure is not misleading. Backtesting over a long period of time could provide insight into how a product works in a particular economic or market environment.
- *Post-sale Practices* – Regulators could consider requiring issuers or distributors to disseminate or make available to investors valuation information of their structured product during the life of the product and to perform regular product reviews.

The consultation report will close for comments on June 13, 2013.

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<sup>3</sup> The SEC's comment letter in April 2012 anticipated this suggested best practice. In its additional guidance to a number of issuers in February 2013, the SEC required that issuers disclose the estimated fair value of a structured product on the cover page of the relevant offering document and provide this information to investors prior to the time of sale.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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