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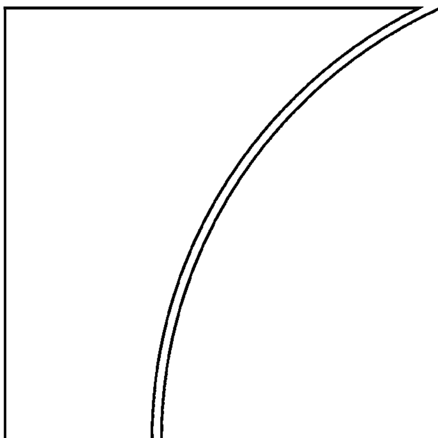
on Banking Supervision

The Joint Forum



Customer suitability in the retail sale of financial products and services

April 2008

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THE JOINT FORUM

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INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS
INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS
C/O BANK FOR INTERNATIONAL SETTLEMENTS
CH-4002 BASEL, SWITZERLAND

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April 2008

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List of acronyms used

ACAM	Autorité de Contrôle des Assurances et des Mutuelles (insurance supervisor, France)
AFM	Autoriteit Financiële Markten (Financial Markets Authority, Netherlands)
AMF	Autorité des Marchés Financiers (Financial Markets Authority, Québec, Canada)
AMF	Autorité des Marchés Financiers (Financial Markets Authority, France)
ASIC	Australian Securities and Investments Commission
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Agency for Financial Services Supervision, Germany)
CNMV	Comisión Nacional del Mercado de Valores (securities commission, Spain)
CONSOB	Commissione Nazionale per le Società e la Borsa (Italy)
DNB	De Nederlandsche Bank (central bank of the Netherlands)
FIEL	Financial Instruments and Exchange Law (Japan)
FINRA	Financial Industry Regulatory Authority (SRO, United States), previously NASD
FOPI	Federal Office of Private Insurance (Switzerland)
FRB	Board of Governors of the Federal Reserve System
FRB-NY	Federal Reserve Bank of New York
FSA	Financial Services Authority (United Kingdom)
FSA	Financial Services Agency (Japan)
IDA	Investment Dealers Association (SRO, Canada)
IMD	Insurance Mediation Directive (European Union)
MiFID	Markets in Financial Instruments Directive (European Union)
NASD	National Association of Securities Dealers (SRO, United States), changed its name on 30 July 2007 to FINRA
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
REITs	Real Estate Investment Trusts
SEC	Securities and Exchange Commission (United States)
SFBC	Swiss Federal Banking Commission
SFA	Swiss Fund Association (SRO, Switzerland)
SRO	Self-Regulatory Organisation

Customer suitability in the retail sale of financial products and services

1. Executive Summary

1. This report considers how supervisors and regulated firms across the banking, securities and insurance sectors deal with the risks posed by mis-selling of retail financial products, including related regulatory requirements, both with regard to disclosure of information to retail investors and requirements on firms to determine whether recommended investment products are *suitable* for such investors. A broad range of supervisors provided details of the regime in their respective countries. These supervisors included sector-based, functional regulators and integrated regulators. For the purposes of this report, we refer to an integrated regulator as one who regulates banking, insurance and securities activity.

2. Our review dealt only with requirements in respect of *retail* customers and products with a significant *investment* component. Our review therefore included investment-based or investment-linked insurance products, but not those insurance contracts that only insure against risk. Credit products sold by banks in retail settings were not part of this review.

3. An important part of our work was to survey some 90 financial firms around the world as to how they deal with customer suitability, and manage the risks posed by mis-selling. We received information from a wide range of firms and we are very grateful for their participation. A number of responses were from firms that operate in more than one sector and/or operate in more than one country or region.

4. Firms almost always treat a natural person as a retail customer. In many instances, even when there is opportunity to distinguish based on net worth or sophistication, firms err on the side of caution.

5. A key finding is that the notion of suitability is recognised in regulatory requirements across all sectors, but to a varying extent. There are some differences in its application by sector, and probably greater differences by country. The differences that do exist may stem, in part, from the fact that not all supervisors have consumer protection mandates.

6. In a minority of the 11 countries surveyed, a consistent suitability regime applies across all three sectors to products that have an investment component. Although it might be observed that such a regime is more frequently associated with countries that have an integrated regulator or a specific 'conduct of business' regulator across the sectors, even where there is substantial variance in suitability requirements between sectors, for example in those jurisdictions where each sector has its own supervisor, there is frequently strong cooperation between the sectoral regulators that helps them collectively to hold firms accountable for improper selling practices.[1]

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[1] For instance, it must be noted that in the US, sales in the retail sector of most investment products deemed a "security" fall under the securities sector's rigorous suitability rules, due to the system of functional regulation in the US. Under this functional approach, the limited number of direct sales of securities by banks are subject to the banking agencies' guidance, while bank subsidiaries and affiliates within bank holding companies selling securities must be registered broker dealers and their extensive sales are subject to the same standards and enforcement by the US securities sector as other securities firms. There is generally a uniform application of suitability requirements to most retail sales in the US.

7. In general, suitability requirements are more specific and enforcement remedies are more likely to be specifically prescribed by securities regulators, or those who have a conduct of business mandate. For example, the securities sector, particularly in the United States, brings the largest number of enforcement actions and imposes the broadest scope of penalties. However, supervisors also oversee firms' compliance with suitability standards through their examination and supervisory processes or other oversight and remedial approaches. This is particularly the case in the banking and insurance sector.

8. In most countries, a suitability requirement only arises when a firm makes a recommendation or provides advice ("advising") to a client to purchase a product.[2] Where no recommendation is made, some jurisdictions require that disclosure be made, or that a client be "warned". Encouragingly, the vast majority of countries will not allow firms to 'contract out' of suitability obligations. An exception to this may occur where a client is deemed to be of sufficient net worth or sophistication that he/she is no longer regarded as "retail".

9. Most regimes require any advice given to be recorded in some fashion and require varying degrees of product information and other disclosures to be made at or before the point of sale.

10. An interesting observation is that disclosure requirements for conflicts of interest (for example, ownership structures of the sales agent, or remuneration to be received) are generally less rigorous for sales of insurance than for other products.

11. In most countries, liability for mis-selling of products will fall to the sales agent, rather than the creator of the product. However a creator may be liable if an agent sells the product, under a jurisdiction's rules of principal and agency. Where a third party makes the recommendation, the suitability obligation will generally fall on that person, though we note that in one country the insurance supervisor requires the creator of the insurance product to satisfy itself that the third party performs its suitability function.

12. Most countries require firms across all three sectors to have dispute resolution procedures in place. In some jurisdictions an independent Ombudsman deals with unresolved disputes while in others an industry-based dispute resolution scheme is available. However, even within countries there can be varying financial limitations applicable to the availability of dispute settlement mechanisms.

13. Supervisors find that requiring firms to have a specific and "independent" compliance function can be a useful tool. Many supervisors mandate this, particularly in the banking and securities sectors. Similarly, many supervisors require key staff to be authorised or registered and for the conduct of sales staff to be supervised.

14. Two related matters that were addressed with supervisors were: what if any role did they play in educating or communicating with consumers regarding financial products and; whether there were any products or services outside their regulatory area of responsibility that gave cause for concern.

15. With regard to investor education, many regulators have websites containing useful information about investing generally and what to look for in selecting financial products and

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[2] For example, in the securities sector of a number of countries (eg United States, Canada, Japan, and European Union) a suitability determination must be made at the time of solicitation (recommendation) and the suitability standards apply upon such recommendation. However, there is no uniform standard across sectors and countries as to when the obligation to make a suitability determination arises.

seeking financial advice. Given their focus, regulators with responsibility for conduct of business regulation appear to provide more information. In some cases, the website is but one part of a broad consumer education programme.

16. A number of regulators expressed concern about a wide range of 'financial products' which fall outside of their regulatory jurisdiction, but which displayed similar functionality and characteristics to regulated products.

17. Bearing in mind its more limited geographical scope,[3] the survey on industry practice confirmed that investment firms, asset managers and banks apply robust suitability policies. Recommendations made to their customers are based on the quasi systematic collection of core information on the financial condition, objectives and risk tolerance of their customers. Insurance companies on the other hand generally have a less comprehensive suitability policy, sometimes as a result of less detailed requirements: they collect on average less information before making a recommendation, and fewer than half of the companies surveyed keep a record of recommendations made.

18. The compliance framework appeared also to be less rigorous in several insurance companies. The investment products offered by insurance companies are less frequently the most risky types of investment products,[4] and some companies noted that for most products sold, the nominal value of the initial investment was guaranteed. They nevertheless raise similar suitability issues. However the situation may significantly vary between countries and there are some minor variations across US states. New legislation entering into force after our survey was conducted should improve the situation in some countries.

19. Beyond the suitability policy, our survey also examined disclosure practices in firms, as disclosure helps customers to make better informed decisions and reduces the risk of mis-selling, even when no recommendation is made. In many jurisdictions, firms generally appear to provide useful information to the customer prior to a sale, particularly with respect to product features and direct costs.

20. However, only 60% of firms consistently provided information on conflicts of interest and remuneration. There was wide disparity even in this figure, with only 40% of insurers saying they provide such information.

21. When looking at the range of information provided to investors when making a sale or recommendation (eg information on product characteristics, risks, expected performance, costs, conflicts of interests), customers were more likely to be asked by the insurance sector to acknowledge that they had received and understood the information provided. However the range of information provided to customers was generally more limited in the insurance sector. In some cases, this would be a result of the type of product.

22. A more encouraging finding was the training that firms provide to sales agents and advisors. Almost all firms include compliance training as part of the overall training programme. Many firms appear to test their employees' understanding of regulatory and firm policy requirements. However, in looking at remuneration arrangements for agents and advisors, only 60% of firms take compliance issues into account in paying remuneration.

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[3] Details of the size of the survey are set out at paragraph 135.

[4] As noted in paragraph 145, none of the insurance companies in the survey indicated that they sold derivatives or hedge funds and only 12% sell foreign products to their customers.

2. Introduction

23. How financial firms approach the sale of financial products and services is at the core of consumer confidence in financial markets and subsequently, has implications for firms' financial soundness and financial system stability as well as investor protection. Different supervisory authorities have different responsibilities for, and therefore different approaches to, the sale of retail products and addressing any evidence of mis-selling. Nonetheless, concerns about the impact of mis-selling are arguably an area where concerns about system stability and investor protection meet.

Definitions

"**Investment product**" is defined for the purposes of this report as an asset acquired for the purpose of earning interest, dividends, or appreciation including traditional products such as stocks, bonds, mutual funds, annuities, and life insurance policies and more complex instruments such as options, hedge funds, variable insurance products, direct participation programs/limited partnerships and real estate investment trusts ("REITs"). Investment products as referenced in this document do not include standard deposit accounts but include deposit accounts having an investment component, such as structured deposits. The "sale of investment products" also refers to investment services related to investment products. Credit products sold by banks in retail settings were not part of this review.

Suitability requirements are defined here as any requirement that a financial firm, when advising a retail client to purchase a particular financial instrument, make a determination of whether that investment is "suitable" or appropriate for that particular client. Suitability or appropriateness are given a broad meaning: "the degree to which the product or service offered by the intermediary matches the retail client's financial situation, investment objectives, level of risk tolerance, financial need, knowledge and experience." The term "**disclosure**" refers to any requirement that the firm disclose information to the retail client that could be material to the investment decision. In a sense, disclosure is intended to assist the retail client in making his/her decision, but is quite distinct from the requirement on a firm to make a determination of whether a particular product is suitable for the client. The term "**mis-selling**" generally refers to the situation where the firm sells a product to a client that is not suitable for that client, whether or not a recommendation is made.

24. The past decade has seen changing social and economic imperatives coincide with developments in markets and firms to create an environment of heightened interest and investment in innovative financial products. As the risks to retail investors of buying products and services not suitable for them increases, so too do the potential risks and costs of mis-selling increase for the financial services industry.

25. The Joint Forum decided to examine existing practices in firms for managing the risk of potential mis-selling and the basic tenets of relevant conduct of business rules across sectors and national borders. A working group on customer suitability was established in March 2006 to address this issue (see paragraphs 35-36 below). It was asked to present its final report by November 2007.

Impetus for consideration of the issue

26. Factors that have increased the potential for mis-selling of financial products and services and interest in the corresponding risks in recent years include:

27. Social and economic imperatives:

- Individuals in many jurisdictions are forced to take greater personal financial responsibility as reliance on the state and employers for retirement/pension benefits decreases.

28. Changing market conditions:

- Relatively low nominal interest rates have been a factor contributing to rising levels of personal debt on one hand and on the other, increasingly complex financial products for savers in search of greater yield. The growing complexity of financial products may make the associated investment risks less apparent to retail investors, particularly investors reaching for higher yield. This heightens the potential for unsuitable transactions.
- Financial innovation has also broadened the scope of financial products offered by the insurance, banking and securities sectors. Similar products may be sold to the retail public in all three sectors.
- Although the producer of a complex financial product is not always its final sales agent, the producer's branding may remain associated with the product. In such cases, the producer may retain some reputation risk, and therefore has an interest in ensuring the proper selling of the product.
- Competition between financial retailers has increased.
- There has been substantial growth in cross-border selling of financial products and services over the last 20 years.
- Legal risk for firms is increasing as the market becomes more litigious. In recent years, an increasing number of collective (class) and official enforcement actions have been brought against financial firms.

The risks around inappropriate sales

29. There are clear consumer/investor protection issues around mis-selling. However, not all supervisors have consumer protection mandates. Understanding what is actually happening in firms and why various sectors look at mis-selling from different perspectives can help to inform the debate about the potential costs of differences in approach and the potential risk of regulatory arbitrage.

30. To this end it is important to understand the wide range of potential risks that cut across the three sectors (banking, insurance and securities), including, but likely extending beyond, concerns about investor protection. For example, there could be broader market implications:

- If mis-selling is alleged and the case won, the compensation payouts could be significant and have consequences for a firm's solvency. This kind of cost is not always picked up in a firms' market and credit risk management models.
- If mis-selling is alleged there is a reputation risk to the firm, with consequent liquidity risks in the short term and solvency risks in the longer term as customers may shun the company.

- There is also a risk of reputation contagion, as firms in one sector, or selling a particular product, are tainted by the actions of a similar firm.
- There is a risk of opportunistic claims with associated reputation, solvency, and distraction risks (ie devoting limited resources to fighting claims).
- Legal uncertainty for firms could hinder financial innovation.

31. The mis-selling of private pensions in the UK in the 1990[s] (see Case Study 4, Annex B) demonstrates the potentially significant impact of mis-selling on firms. The firms involved have paid some billions of pounds in compensation.

32. In the Netherlands, a more recent case (see Case Study 5, Annex B) involved a firm paying one billion Euros in compensation to customers and withdrawing from the market in that country.

Potential mitigation

33. Just as supervisory responsibilities and the way supervisors view the risks of mis-selling differ, so do the potential mitigating actions of supervisors and the firms they supervise.

34. Conduct of business rules, which include in particular suitability requirements, are key to mitigating the risks of mis-selling. Firms across the three sectors also protect themselves by risk mitigation activities such as:

- Exercising robust risk management regarding the production of new products and services, including the clear identification of the target market;
- Establishing an appropriate incentive structure for sales forces, and
- Conducting comprehensive risk analyses of new products crossing business lines, including analysis of the legal, accounting, tax, and corporate structure risks entailed in such products.

The present report

35. In order to build up useful background information and to further the understanding of the potential for regulatory arbitrage, a specific regulatory sub-group was created within the working group to survey supervisors regarding their approaches. The results constitute Section 3 of the present report.

36. An Industry sub-group was also set up within the working group to review the practices employed by firms to determine suitability of a product to its consumer and prevent mis-selling (see Section 4 of the Report). The sub-group covered, among other things, the following areas:

- How a firm assesses its obligations to make a suitability determination before a sale is made to a retail customer.
- Whether any distinction is made between retail and institutional customers.
- The type of information that a firm seeks to obtain about its end customers in the course of making a sale, and under what circumstances.
- The type of information that firms disclose to their customers that enable them to better understand the associated risks.

- The extent to which the processes in firms related to the design and approval of new products and services address reputation and legal risks, the potential for conflicts of interest, and other suitability considerations.
- The extent to which firms' responsibility for sales agents with regard to suitability obligations is considered within risk management frameworks.
- Risk management practices related to record-keeping of suitability determinations.
- Any unique processes and considerations in firms with respect to specific kinds of financial products, such as options, fixed income products, government securities (including municipal securities), hedge funds, variable insurance products, variable annuities, direct participation programmes/limited partnerships, real estate investment trusts ("REITs"), and other non-conventional investments, some of which cross traditional sectoral lines.
- The degree to which a firm feels it may disclaim its responsibilities and so remove liability and reputation risk.

37. Responses to the industry survey were received between the end of September 2006 and February 2007 and correspond to the practices followed in the firms at the time of their responses. The responses to the survey on regulatory requirements includes references to enacted legislation that had not yet become effective when the industry survey was conducted. This is in particular the case for the Directive on Markets in Financial Instruments (MiFID) in the European Union and Financial Instruments and Exchange Law (FIEL) in Japan. In addition, subsequent to the survey period, the Federal Reserve and the SEC, in consultation with the other US banking regulators, adopted Regulation R, which implements the bank exceptions from the definition of broker-dealer contained in the Gramm-Leach-Bliley Act. This may explain why in some instances the practices described in section 4 appear not to be in accordance with the regulatory requirements described in section 3. [5]

38. A collection of Case Studies is included as Annex B of this report. The cases chosen provide examples of mis-selling or cases where conflicts of interest were not properly handled. The cases illustrate the potential impact on customers and firms.

[5] For instance, 2 banks and several insurance companies are described as not having a compliance function covering suitability issues in section 4-B-6, but have come recently under the obligation to have one (sections 3-E-1 and 3-E-5)

3. Regulatory requirements

39. Supervisors in several countries contributed to this report by completing a survey on the requirements in their respective regimes regarding customer suitability.

40. The questionnaire on regulatory requirements focused on "requirements" defined as any enforceable legal obligation where non-compliance can be sanctioned by a supervisory authority (including an SRO). This is meant to include laws, administrative or professional regulations, or other legally binding requirements and can include supervisory or regulatory guidelines, provided they are enforceable. Supervisors were also encouraged to describe other standards, such as those contained in non-binding supervisory or regulatory guidance, or voluntary codes of conduct, but were asked to clearly distinguish them from requirements as defined above.

41. The regulatory agencies, sector and geographic coverage is as follows.

Table 1: Responses to the survey on regulatory requirements

Countries	Banks	Insurance	Securities
Australia	ASIC	ASIC	ASIC
Canada	-	Financial Services Commission, Financial Institution Division (Saskatchewan Province)	AMF (Québec Province) Investment Dealers Association (IDA)
France	Joint response AMF/Commission bancaire/ACAM	Joint response AMF/Commission bancaire/ACAM	Joint response AMF/Commission bancaire/ACAM
Germany	BaFin	BaFin	BaFin
Italy	CONSOB	CONSOB	CONSOB
Japan	FSA	FSA	FSA
Netherlands	AFM/DNB joint response	AFM/DNB joint response	AFM/DNB joint response
Spain	Joint response: Bank of Spain/CNMV/ General-Direction of Insurance and Pension Funds	Joint response: Bank of Spain/CNMV/ General-Direction of Insurance and Pension Funds	Joint response: Bank of Spain/CNMV/ General-Direction of Insurance and Pension Funds
Switzerland	SFBC	FOPI	SFBC
UK	FSA	FSA	FSA
United States	Joint response FRB OCC, SEC, NASD (now FINRA) and NYSE	Iowa Insurance Division representing the NAIC	Joint response FRB OCC, SEC, NASD (now FINRA) and NYSE
European Commission	MiFID (where applied to investment services)	Insurance Mediation Directive	MiFID

Note: table 1 lists the agencies who responded to the survey (for the EU, the texts reflected in the response), and does not necessarily describe the supervisory responsibilities for the respective sectors. For instance, in Australia, a separate Agency provides prudential supervision of banks and insurance companies.

42. For some countries, the survey results do not cover all applicable laws and regulations. For example, only two Canadian provinces answered the survey, Saskatchewan and Quebec. However the securities regulations and the insurance requirements are consistent and highly harmonised across Canada. With respect to the United States, Iowa responded on behalf of the National Association of Insurance Commissioners (NAIC) with representative answers of US practices in the insurance sector, as the Iowa commissioner leads the NAIC effort on customer suitability issues , and no US state securities commission was included in the survey. However, the US federal banking and securities regulators provided a comprehensive country report.

The European Directive on Markets in Financial Instruments or MiFID :

The Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 contains conduct of business obligations that apply to investment firms and credit institutions when providing investment services and ancillary services as defined in the Directive.[6] It is complemented by an implementation directive (Commission Directive 2006/73/EC of 10 August 2006) that includes in particular a section on the assessment of suitability and appropriateness (art. 35 onwards).

This directive[7] requires Member States to adopt the laws, regulations and administrative provisions necessary to comply with it by 31 January 2007, and to apply these measures beginning 1 November 2007. Rather than describing the various suitability regimes that existed before MiFID, the present section of the report primarily describes the customer suitability framework for investment services provided by MiFID. Where relevant and necessary for contrast and clarification, however, the report also describes some specific national regulatory requirements and supervisory practices in certain EU countries

The European Directive on Insurance Mediation or IMD

A similar approach has been taken as regards the insurance sector in the European Union with the Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation. The Directive requires that all intermediaries be registered in their home Member State. To obtain that registration, they need to meet certain professional requirements. Once they have done so, they are free to sell their services anywhere in the EU. The transposition deadline in Member States was 15 January 2005. The Directive, which is based on a September 2000 proposal from the Commission (see IP/00/1048), replaces a 1977 Directive and becomes the only binding EU law covering individuals or companies selling insurance products on behalf of others.

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[6] Article 1 MiFID. Investment services and activities are defined in article 4 of MiFID and refer in particular to a list of activities in Mifid Annex I-A (reception and transmission of orders, execution of orders, dealing on own account, portfolio management, investment advice, underwriting of financial instruments and or placing of financial instruments on a firm commitment basis, placing of financial instruments without a firm commitment basis, operation of Multilateral Trading Facilities) related to financial instruments listed in Mifid Annex I-C. Ancillary services are listed in Annex 1 B and include for instance granting credits or loans to an investor to allow him to carry out a transaction in a financial instrument, where the firm granting the credit or loan is involved in the transaction.

[7] As amended by Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006 amending directive 2004/39/EC on markets in financial instruments, as regards certain deadlines

A. Role of the regulatory authority

1. Sector coverage of the authorities in charge of suitability requirements

43. Some countries have sector-specific regulators (United States, Canada, and, in the case of the insurance sector, Spain, France and Switzerland) and alternatively, or in addition, specific self-regulatory organisations (SROs) in the securities sector (United States with the New York Stock Exchange – NYSE and the National Association of Securities Dealers – NASD, which on 30 July 2007 changed its name to Financial Industry Regulatory Authority – FINRA; Canada with IDA, Switzerland. In the United States, there is a single national securities regulator, a number of federal banking regulators,[8] but no national insurance regulator. Each state has its own insurance commission. The National Association of Insurance Commissioners (NAIC) is an association and coordinating group comprised of state insurance regulators from each state in the United States. US banks generally engage directly in securities transactions as agent and in connection with other banking services, such as trust and fiduciary and custody services. US banks also enter into networking agreements with affiliated and unaffiliated broker-dealers and consistent with functional regulation, those broker-dealers are subject to the regulatory regime of the securities sector.

44. Other countries have a single regulator primarily in charge of conduct of business rules across all three sectors (Australia, Germany, Italy, Japan, Netherlands, United Kingdom, and, in the case of securities firms and banks providing investment services, France and Spain). [9]

2. Enforcement actions

45. Enforcement of suitability and conduct of business requirements generally, are seen by many regulators to be an important tool to ensure firms meet their obligations. Several of the regulators have taken significant enforcement actions in recent years on these issues.

46. Differences in enforcement approaches appear to be more meaningful among regulators, rather than what is regulated. However, the securities sector, particularly in the United States, brings the largest number of enforcement actions and imposes the broadest scope of penalties.

47. Several banking and insurance regulators stated that their examination and supervisory processes are appropriate ways of overseeing and addressing shortcomings in firms' compliance with their obligations under applicable suitability standards, which does not exclude the use of enforcement authority where appropriate.

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[8] Note on scope of responses of US banking sector: This summary reflects US federal banking regulators' approach to customer suitability in direct bank sales to retail customers of corporate securities and other non-deposit investment products. The sale of federal and local government securities is subject to a different regulatory regime, which was described in the responses to the questionnaire, but is not reflected, in this more general summary. Similarly, the rules relating to customer suitability in direct bank sales of insurance and annuities are described in the questionnaire, but are not included in this summary. In addition, securities transactions related to trust activities are not covered in this summary or in the questionnaire because they are subject to fiduciary principles governing such trust activities. Finally, credit products sold by banks in retail settings were not part of this review.

[9] In Italy, in the framework of the transposition of MiFID, joint regulatory functions concerning the organisational requirements of the intermediaries has been given to Banca d'Italia and Consob

B. Description of suitability requirements

1. Definition of retail customer

48. In general, the term "retail customer" is not defined. Instead, anyone who is not an "institutional" or "professional" investor (eg meets certain minimum net worth levels or is a corporation or trust) is generally treated as a retail customer. Suitability requirements apply to both, but may be applied differently (United States, Australia, European Union under the MiFID regime, Canada, and Spain (insurance)). The German insurance sector appears to be an exception, as a retail customer must be a "natural person" or limited and general partnerships.

49. Of those jurisdictions that answered the question whether accounts held by natural persons can be considered non-retail, several but not all would permit, such an account to be considered non-retail in certain circumstances (eg where the client chooses to be considered "professional" subject to certain objective criteria).

2. The suitability determination

a. When and if a suitability determination must be made

50. **In the securities sector,** there is generally a requirement that a determination must be made as to whether a product is suitable for a retail customer at the time of solicitation (recommendation) and that a recommendation must be made in order for the obligation to arise (United States, Canada, Japan, and European Union). In the European Union, MiFID will require firms to assess the "suitability" of a service or transaction when providing services that entail an element of recommendation on the part of the firm (ie investment advice and portfolio management).[10] In Australia, the obligation is imposed whenever "personal advice" is given to a retail client prior to sale, including portfolio management.

51. In Japan, financial firms also have an obligation to provide material information regarding the financial instruments being sold to retail customers, irrespective of whether a sale is solicited. The nature of the disclosure requirement will vary depending on the characteristics of the investor (eg) whether the investor is a retail client or not).

52. The firm-customer-relationship in the distribution of retail products is in Switzerland governed by a classic civil law principal/agent relationship under which the agent has some general duties. Inter alia, a fiduciary obligation may emerge under certain circumstances. The nature of the fiduciary obligation, if any, will depend on the type of contractual relationship between the client and the bank/securities dealer (eg portfolio management, investment advice or execution-only brokerage account). Under the latter type of account, there would usually be no fiduciary duty, yet, even then, if a relationship of mutual trust has developed between the firm and the client, the firm is obligated (without being asked) to "warn" the client of any risks and provide a recommendation concerning an investment.

53. In the banking sector, MiFID will impose in the European Union the same requirements as in the securities sector, ie credit institutions that provide investment services will be subject to the same rules as "pure" investment (ie securities) firms. In Australia, banks are treated in the same way as securities firms when "personal advice" is provided to a "retail client". Swiss rules, as described above, would also apply regardless of whether a bank or a securities firm sells the service or transaction. In Japan, after the enactment of the Financial

[10] MiFID Article 19 (4).

Instruments and Exchange Law (FIEL), the suitability requirements would also be applied to deposits with substantial investment characteristics.[11] In the US banking sector, the bank regulators' guidance provide that "if bank personnel recommend non-deposit investment products to retail customers, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer on the basis of information disclosed by the customer."

54. In the insurance sector, the EU *Insurance Mediation Directive* (IMD) imposes disclosure and other requirements prior to the sale of an insurance contract (eg the firm must provide the client with substantial information about the product, and specify the "demands and needs" of the customer as well as the underlying reasons for any advice).[12] In the insurance sector in the United States, both carriers and "producers" (agents) must make a determination of suitability of ***annuity products*** prior to recommending a sale. With regard to ***life products***, the producers (but not the carriers) must determine that the product recommended is not "unsuitable." Japan imposes the same suitability requirements to insurance products with substantial investment characteristics as they do in the banking and securities sectors under the FIEL. Australia imposes suitability requirements where "personal advice" is provided in relation to products defined as "general insurance products" (ie insurance products provided to "retail clients").

b. Definition of the term "recommendation"

55. Most jurisdictions do not define the term, with the exceptions of the US NYSE and US insurance statutes. Australia defines "advice," not recommendation. EU (MiFID) defines "personal recommendation" in the context of "investment advice".

c. Any rules applicable to trades made without a recommendation

56. In most jurisdictions, there is no rule requiring a firm to ensure the suitability of a transaction made without a recommendation.

57. Several jurisdictions have special rules applicable to certain types of products, which may prevent or discourage an investor from purchasing, eg by requiring special disclosures prior to the sale and/or warning the client about the risks, or a determination that the products are not suitable for the client to purchase (eg US SEC, Netherlands). In the EU, where a firm does not make a personal recommendation to a client, who seeks and obtains services *other than* financial advice or portfolio management (eg where he/she asks simply that an order be executed), MiFID requires the firm to apply an "appropriateness" test, ie to assess whether the client or potential client has the knowledge and experience to understand the risks involved in the transaction for the sale of any investment product or service.[13] Should the firm consider that, on the basis of the information obtained from the client, the investment product or service is not appropriate to the client or potential client, the firm is required to warn the client. In cases where the client does not provide the information needed to perform the test, or provides insufficient information, firms are required to warn the client that the firm does not

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[11] For instance, foreign currency deposits (deposits that may incur loss of principal denominated in Japanese yen due to fluctuations in foreign exchange rates)

[12] As indicated earlier, MiFID applies to the provision of investment services by investment firms (see definitions in Article 4 and Annex I of MiFID). The Insurance Mediation Directive applies to taking-up and pursuit of the activities of insurance and reinsurance mediation. If an intermediary provides both types of services it will have to comply with both set of rules.

[13] MiFID Article 19(5).

have sufficient information to determine whether the service or product envisaged is appropriate.

58. In connection with any retail sales of non-deposit investment products, US banking regulators' guidance provides for disclosures of risk and the fact that the investments are not government insured bank deposits or obligations and are subject to investment risks, including the loss of principal. US bank regulators are reviewing this guidance to determine appropriate revisions based on changes implemented by recent statutory and regulatory provisions.

d. Possible Disclaimer of Suitability Obligations

59. It appears that no jurisdiction permits a firm to disclaim its suitability obligations. However, firms can generally sell to a client a product that it deems inappropriate for the client, as long as it does not recommend the purchase. In the securities sector, some jurisdictions, (including some countries within the EU), require that before such sales take place, firms must warn the customer if investments are not appropriate for them (see c above).

e. Exemption from the suitability obligation

60. In the insurance sector in the United States generally, a firm has no suitability obligation with regard to ***annuity sales*** if a consumer (1) refuses to provide relevant information; (2) decides to enter into an insurance transaction that is not based on a recommendation; or (3) fails to provide complete and accurate information.

61. Otherwise, suitability obligations generally apply when a recommendation has been made, but there are nuances related to the applicability of such an obligation in some instances. For example, in some jurisdictions, a suitability obligation:

- Does not apply to "general" (versus "personal") advice (Australia, European Union under MiFID).
- Is subject to exemptions for "professional" investors (Japan under FIEL; Netherlands). In Japan, a "general investor" may change his/her status to "professional" pursuant to certain standards and procedures. In the European Union under MiFID, a less rigorous suitability requirement applies where products are sold to professional clients, taking into account the client's experience, knowledge, and financial resources.
- Further, under MiFID, in the case of execution only services (but in non-complex products only) the "appropriateness" test is not applied, provided that the service is provided at the initiative of the client, that the client has been clearly informed that the firm is not required to assess the suitability or appropriateness of the instrument or service offered and accordingly that the client will not have the benefits that would otherwise be provided by suitability and appropriateness determinations.
- Under the Insurance Mediation Directive (IMD), a customer need not be provided with information (that would otherwise be provided) if the insurance firm acts as an intermediary with regard to either the insurance of large risks or reinsurance.

f. Information that must be obtained from customers

62. In the **securities and banking sectors**, firms in accordance with regulations or supervisory guidance obtain certain types of information on the basis of which the firm has to determine the appropriateness or the suitability of a particular investment. This information generally includes the client's financial situation (regular income, assets, etc.) and his

investment objectives (risk profile, including risk taking preferences, etc.) and/or level of knowledge/experience in the investment field (types of services, nature, volume and frequency of transactions, etc.).

63. A few jurisdictions have specific requirements that the information be kept current, namely Canada and the US SEC (updated every 36 months). The US banking sector's guidance provides that the information should be updated periodically. One jurisdiction stated that there is no explicit rule that the information be kept up-to-date, however, it is expected that information will be updated prior to a sale of a financial product that is new to the customer (Switzerland).

64. Under MiFID, it is not explicitly stated how often the information about the client has to be updated. The requirement to update this information is implied, however, because the firm is required to ensure that the recommendation or service provided is suitable or appropriate; and this is not possible if the information is not updated. Australia's position is similar to that of the European Union under the MiFID. Similarly, in Japan, even though there is no rule directly requiring firms to update the information obtained from its customer, firms must in practice update the information, since firms must take into account customer information (objective, expertise, experience, and assets) at the time of or prior to solicitation.

65. In the **insurance sector**, it appears that, in some jurisdictions, the same requirements apply (Japan, Netherlands, Canada, Australia and, for annuity sales only, in the majority of US states). The United Kingdom also requires the same information in respect of investment life products.

g. Recordkeeping Requirements relating to Suitability Determinations

66. In the **securities and banking sectors**, there is a split of approaches, although the end result may be the same. Two jurisdictions (Australia and the Netherlands) specifically require that any "advice" to a client must be documented. Australia requires the creation of a Statement of Advice, while the Netherlands requires the recordation of the basis for, and any other relevant information relating to, any advice. In the European Union, the Committee of European Securities Regulators (CESR) has recommended to its members that under MiFID, the competent authorities should require that a record be made of the fact that investment advice has been rendered to a retail client, as well as of the financial instrument that was recommended. Switzerland requires documentation evidencing that disclosure requirements have been satisfied. Most other jurisdictions do not have a specific documentation requirement for suitability determinations, but have general recordkeeping requirements that would cause the firm to document the basis for any suitability determinations (US securities sector, Canada). US banking regulators' guidance includes similar standards.

67. In the **insurance sector,** Germany requires its insurance firms to document any advice given and the basis for that advice. In the US, the majority of state insurance commissions require that a record of some type must be created to document that the recommendation was suitable. The documentation must be preserved for ten years. In addition, a reasonable effort must be made to obtain the suitability "information," and such information collected from the consumer must be maintained and made available to the commissioner of insurance. However, the obligation is eliminated if the consumer refuses to provide relevant information or fails to provide complete or accurate information.

3. Disclosure requirements concerning financial products

68. There is a broad range of disclosure requirements in all three sectors, and it appears impossible to generalize as to differences between sectors. However, it is possible to characterize the differences between regulators

69. Australia imposes comprehensive disclosure requirements for financial products sold ***in all three sectors*** to "retail customers". This includes Product Disclosure Statements, including fees and charges, and updates to those statements via a periodic statement. Firms must also provide customers with a Financial Services Guide, which provides information about the firm, and a Statement of Advice whenever a recommendation is made, including disclosure of any conflicts of interest.

70. MiFID also contains extensive disclosure requirements applicable to investment firms and credit institutions when providing investment services. The information required includes details about the investment firm and its services, the financial instrument and the proposed investment strategies (including risk warnings), execution venues and costs and associated charges.[14] These are in addition to information that must be disclosed to clients concerning conflicts of interest[15] and fees and commissions indirectly paid by the client to a third party in relation to an investment service provided by the firm ("inducements"[16]).

71. Most other regulators seem to impose less extensive requirements or supervisory guidance. Among others, there are obligations to disclose conflicts of interest (US securities sector, Canada securities sector), confirmation disclosure obligations, and product- specific disclosure requirements, including in connection with the opening of a margin account (US and Canadian securities sector), high-risk and/or complicated transactions such as derivatives (Japan-securities sector) or "all information that can be considered necessary" for an investor to evaluate a financial product adequately (Netherlands—all sectors).

72. Under Swiss law, a securities firm is required to make certain disclosures to its client.[17] In particular, the firm is required to bring to the attention of the client specific risks associated with a particular type of investment, but not necessarily the risks associated with a particular transaction. In satisfying this disclosure requirement, the firm must, to the degree that this information is available to the firm, consider the experience and knowledge of the client with respect to securities trading. However, it is apparently not required that the firm affirmatively obtain such information from the client.

73. For direct securities sales by banks in the United States, the primary focus of the banking regulators' guidance is to ensure bank disclosures make it clear to retail customers that such securities are not government insured bank deposits or obligations and are subject to investment risks, including the loss of principal. In addition, the banking agencies' guidance sets forth supervisory expectations related to the circumstances in which it is appropriate for banks to provide conflict of interest information. US bank regulators are reviewing this guidance to determine appropriate revisions based on changes implemented by recent statutory and regulatory provisions.

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[14] MiFID, Article 19(3) and Articles 27 to 34 of Directive 2006/73/CE..

[15] MiFID Article 18.2 and Articles 22 and 30 of Directive 2006/73/CE

[16] Directive 2006/73/CE, Article 26.

[17] BEHG, Art. 11. (Federal Act on Securities Exchanges and Securities Trading of 24 March 1995)

74. In the Japanese banking and securities sectors, after the enactment of FIEL, disclosure must be made concerning the fact that the principal portion of certain investments is not guaranteed, but there is also an obligation to disclose possible risk of loss in excess of principal invested, and also the market and credit risk to which certain investments may be subject.

75. In the Japanese **insurance sector**, the disclosure requirements under FIEL appear to be as broad as they are in the banking and securities sectors. For example, sufficient disclosures must be made for the customer to understand the investment. Moreover, the disclosure must describe investment strategies and risks relating to variable annuities.

76. The EU imposes disclosure obligations concerning the terms of a non-life insurance contract.[18] More detailed disclosure obligations exist with regard to life assurance.[19]

77. In the US insurance sector, in some states, regulations govern the use of illustrations by insurance companies (eg all illustrations must follow a standardized format and must provide clear disclosure of any kind and all applicable expense loads and charges including withdrawal, surrender, and mortality charges, and clearly identify the contract represented by type and form number). There is also a requirement for an annual report for some life insurance policies. Non-variable annuities are subject to product-specific disclosure requirements – and the insurance company must provide its customers with the NAIC Annuity Buyer's Guide of the National Association of Insurance Commissioners. Variable annuities and variable life insurance are subject to SEC disclosure requirements, because they are considered securities. US banks' sales of insurance and annuities are subject to mandated customer disclosure requirements that discuss the products' associated risks.

4. Suitability obligations with regard to specific products

78. In the **banking and insurance sectors,** in general there currently are no additional obligations with regard to more complex or specific types of investment products. In the US banking sector, the banking regulators' supervisory guidance applies to direct bank sales of securities and other non-deposit investment products to retail customers.

79. In the **securities sector**, several jurisdictions have specific rules. The US securities sector (primarily the SEC and the FINRA) has very comprehensive product specific rules addressing the sales of certain OTC securities (including penny stocks), municipal securities, a certain type of university savings plan, direct participation programmes or limited partnership transactions, investment company securities, warrants and options, and securities futures. In addition, Canada has specific rules applicable to derivatives products. In Switzerland, whenever investment funds pose a materially distinct risk when compared to securities and real estate funds, that distinct risk needs to be specially disclosed. In the European Union, MiFID requires firms to provide clients or potential clients with a general description of the nature and risks of financial instruments, taking into account, in particular, the client's categorisation as either a retail client or a professional client. That description must explain the nature of the specific type of instrument concerned, as well as the risks particular to that specific type of instrument in sufficient detail to enable the client to make investment decisions on an informed basis. The description of risks must include specific

[18] Directive 92/49/EEC, Article 31.

[19] Annex III.A, of Directive 2002/83/EC.

elements, where relevant to the status and level of knowledge of the client and to the specific type of instrument concerned. This requirement applies to any kind of financial instrument.[20]

80. In Japan, suitability obligations under the FIEL shall apply to a broader spectrum of specific types of investment products, including mutual funds, derivatives, and other banking and insurance products with substantial investment characteristics.

81. As noted earlier, in the insurance sector of the majority of US states, with regard to the sale of annuities, carriers and producers must make a suitability determination whenever they recommend the sale of the annuity. With regard to life products, producers must make a determination that the product is “not unsuitable.”

5. Sales programmes requirements

a. Liability of the “manufacturer” of a financial product when a sale is made through a third party.

82. Generally, where there is no contractual or agency relationship between the manufacturer and a third party distributor there is no liability of the manufacturer for the actions of the third party in selling or mis-selling a product (eg US securities, banking and insurance sectors, Australia (all sectors). Manufacturers could however still face reputation risks. Manufacturers generally are responsible under normal agency principles when they use tied agents.

83. In the European Union, under MiFID, member states may allow investment firms to appoint tied agents for the purposes of promoting the services of the investment firm, soliciting business or receiving client orders, transmitting orders and providing advice in respect of financial instruments and services offered by that firm[21]. If member states make use of this option they must require that the investment firm retain full legal responsibility for any action or omission on the part of the tied agent[22]. Additionally, MiFID[23] specifies the allocation of responsibility where an investment firm provides a service through the medium of another investment firm. European member states are free to organise the relationship between the producer and the distributor and to determine the responsibilities of the producer.

84. In the **insurance sector** the situation is generally the same. Interestingly, in the insurance sector in the United States, even though the insurer is generally not liable if the sale of an annuity is made through a third party, the insurer nonetheless “must make reasonable inquiries to assure that the third party is performing the suitability function.”

85. Under the EU’s Insurance Mediation Directive (IMD), two options are possible: either the insurance intermediary using a third party remains responsible, or the third party is

[20] See Article 31 of Directive 2006/73/CE

[21] Article 23(1) MiFID; article 4 of the same directive defines tied agents as “a natural or legal person who, under the full and unconditional responsibility of only one investment firm on whose behalf it acts, promotes investment and/or ancillary services to clients or prospective clients, receives and transmits instructions or orders from the client in respect of investment services or financial instruments, places financial instruments and/or provides advice to clients or prospective clients in respect of those financial instruments or services.”

[22] Article 23(2) MiFID

[23] Article 20 MiFID

himself to be considered an intermediary under the IMD and hence, must fulfil all of the IMD's requirements.

b. Suitability or other requirements that address conflicts of interest

86. There is a broad range of requirements regarding disclosure of remuneration, ownership and other potential conflicts of interest across sectors, although there appear to be far fewer such requirements in the insurance sector.

87. Sometimes the rules are very specific and detailed (eg Australia for all three sectors; Canada-securities sector; Netherlands-banking sector; US-securities sector (FINRA rules); EU under MiFID). Sometimes the requirement to disclose conflicts arises out of a more general duty of fair dealing with the customer (US Securities sector/SEC, Canada and Germany insurance sector; Switzerland-banking sector). In the US banking sector, the bank regulators' guidance sets forth the circumstances in which banks should disclose conflicts of interest.

C. Supervisory monitoring and specific actions

1. Inspections

88. The differences in approaches with regard to inspections of whether firms are meeting their obligations appear to be country-, rather than sector-specific, though all countries have an inspection regime. In some jurisdictions all firms are inspected, in others fewer firms are inspected, in a targeted approach.

89. Regulators in seven countries indicated that they conduct inspections. Of those, some regulators conduct the inspections themselves or through self-regulatory organisations (US SEC, NYSE and FINRA for the securities sector; US banking and insurance regulators; Canada and IDA for the securities sector and by the FID in the insurance sector; Japan and Italy in all three sectors, French AMF for investment firms and credit institutions providing investment services). In Switzerland, in the insurance sector, the Bundesamt für Privatversicherungen (BPV or Federal Office of Private Insurance FOPI) usually conducts inspections itself, although it hires external auditors for special investigations. The Swiss banking and securities regulator, SFBC, has a different approach. Large banking groups are inspected by the SFBC and by outside auditors, whereas small and medium banks are inspected by outside auditors. German securities and banking regulators retain outside auditors to inspect firms.

2. Imposition of sanctions for non-compliance with disclosure, customer communications, or suitability requirements

90. During a three-year period, the greatest number of cases brought that resulted in sanctions for non-compliance with disclosure, customer communications, or suitability requirements were in Australia (all three sectors—approximately 2916 cases[24]) and the US securities sector (SEC, NASD, NYSE) (approx. 1739 cases). In addition, about 300/cases per year (or about 900 in a three year period) were brought in the Netherlands in all three

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[24] This number includes outcomes that other jurisdictions may not consider "sanctions," particularly with regard to 1744 matters classified as "other significant outcomes," which include administrative actions, lodging of replacement and supplementary documents and matters resolved by agreement. (See ASIC response to question 3(a) of the questionnaire.)

sectors. In Italy, Consob imposed pecuniary sanctions on 750 corporate officers and 40 financial intermediaries with regard to violations of suitability and disclosure obligations, and related procedural and internal control duties.

91. Sanctions were also imposed during the same three year period as follows: UK FSA for all three sectors (8 cases); France securities sector (6 cases); Japan (one case in each of the securities and banking sectors). Sanctions were imposed in a "few" cases in the Swiss insurance sector.

92 In the US insurance sector, the Iowa Insurance Division, using its own experience, confirmed that it has sanctioned carriers and producers for failure to comply with suitability requirements. However, it indicated that it cannot easily quantify the number since its "order" database, which lists the orders, revocations, and suspensions that have been issued, does not include a subject matter category.

93. Otherwise, most jurisdictions have not imposed sanctions. For example, some regulators say that they prefer more "informal measures than imposing fines" (insurance sector in Germany). In the US banking sector, the US banking regulators would address violations of their suitability guidance through the examination and supervisory processes. If a bank's failure to develop and adhere to appropriate policies and procedures violated applicable law or regulation or threatened the safety and soundness of its operations, the US banking regulators could bring a formal or informal[25] enforcement action.

3. Imposition of sanctions for failure to supervise compliance by an agent or third party related to disclosure, customer communications, or suitability requirements

94. Far fewer such cases have been brought in comparison to the previous question. For some countries, failure-to-supervise cases are part of the statistics provided above (eg Australia, US-securities sector NASD, France-securities sector).

95. Only Canada, the US SEC, NYSE and NASD (securities sector) identified cases that have been brought for failure to supervise in the last three years. The NASD, for instance, has brought over 100 failure-to-supervise cases in the last three years. An interesting example of a failure to supervise case comes from Canada, where, after intervention from regulators that are members of the Canadian Securities Administrators (CSA)[26] and the SROs, numerous registered dealer firms agreed to take steps to have their salespersons return commissions they had received in connection with investments in Portus Alternative Asset Management, a major hedge fund.

96 US banking sector guidance provides that banks should conduct appropriate due diligence of third parties; ensure that relationships with those third parties are governed by a written agreement that requires the third parties' compliance with applicable laws and regulations and applicable banking sector guidance; and monitor the third parties' compliance with the terms of the agreement. A bank's failure to monitor compliance may

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[25] Informal enforcement actions include commitment letters and memoranda of understanding entered into between a bank and its banking regulator that typically set out a corrective action plan to address the regulator's supervisory concerns. These actions are generally not public.

[26] The CSA, the council of the securities regulators of Canada's provinces and territories, coordinates and harmonises regulation for the Canadian capital markets.

result in the imposition of a corrective action plan through formal or informal enforcement action.

D. Customer redress: private courses of action and/or arbitration

97. In most jurisdictions in all three sectors, customers have a private course of action to seek redress. In most jurisdictions, this is through mediation or arbitration forums (North America) or an "ombudsman" (Europe).

98. In the US securities sector, broker-dealers and their customers generally enter into contracts providing that they will arbitrate their disputes in a forum operated by an SRO. In addition, SRO rules provide that, absent an agreement, broker-dealers must arbitrate disputes at the customer's option. Customers who buy securities from US banks may bring a private action in court, including for allegations of fraud. Broker-dealer customers may bring actions for fraud or violation of SRO sales practices rules. In Italy, the violation of any Consob regulation can serve as the basis of a private course of action and in addition, an alternative dispute resolution (ADR) mechanism is being set up with the involvement of Consob. Other jurisdictions may set forth specific requirements for the bringing of a private action in all three sectors (eg Australia, in relation to a failure to provide a disclosure document or providing a defective disclosure document.

99. Some jurisdictions across sectors require firms to belong to a dispute resolution scheme (eg Australia), while others have set up a separate body or association to settle individual disputes (UK) or mediate claims (Japan). In the EU, MiFID obliges EU member states to "encourage" the establishment of efficient out-of-court complaints and redress mechanisms, but also allows Member States to use existing bodies where appropriate.[27] Most European countries have established such mechanisms. For instance, in France, there has been an ombudsman with the AMF since 1997, whose role is, in the event of a dispute, to help the parties reach an out-of-court settlement, within a procedure, which is free of charge, confidential and elective (requiring the consent of both parties). In the Netherlands the Act on Financial Supervision sets out the obligation for firms to establish adequate procedures for customer complaints and to join an alternative dispute resolution body which is recognized by the Minister of Finance. As an additional means for customer redress, one should also note that in the European Union, investment firms and credit institutions providing investment services are required to be members of an authorised Investor Compensation Scheme.

E. Regulatory requirements on risk management processes

1. Responsibilities imposed upon firm management to monitor compliance

100. A number of jurisdictions require firms to establish and maintain a system to supervise the activities of key employees and associated persons, which is reasonably designed to achieve compliance with applicable laws and regulations (US securities and banking sectors, Italy-all sectors, Australia-all sectors, Canada-securities sector, Japan-all sectors, Switzerland-banking and securities sector, European Union (banking and securities). Under MiFID, senior management and, where appropriate, the "supervisory function" (defined in article 9 of MiFID implementation directive as "the function within the firm responsible for the supervision of its senior management") are responsible for ensuring that the firm complies with its obligations under MiFID. This means that senior management and

[27] MiFID, Article 53.

the "supervisory function" must assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the firm's obligations under MiFID and to take appropriate measures to address any deficiencies. Senior management must receive at least annually, written reports on compliance, risk management and internal audit. The "supervisory function", if any, must receive on a regular basis written reports on the same matters. Similar requirements exist in the US securities sector.

101. Additionally, in Italy, Consob regulations require a firm's internal control function to provide to the board of directors and board of auditors a report on complaints received and on potential organisation and/or procedural shortcomings so that appropriate remedial actions may be taken.

102. The French Banking Commission and the AMF require investment services providers to have a specific compliance function within the permanent control function or directly linked to the executive body. Effective 1 January 2007, the Swiss Federal Banking Commission imposed on banks and securities dealers the requirement to establish a compliance function that must report once a year to senior management.

2. Requirements to train employees

103. A number of jurisdictions have continuing education/training and examination requirements or standards to help ensure compliance with applicable laws and regulations (US securities and banking sectors; Japan-securities sector; Canada-securities and insurance sectors; Australia and Switzerland -all three sectors; France-securities sector). In Japan, training is required in the banking and insurance sector to "ensure that customer suitability requirements are met."

104. MiFID requires investment firms to employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them. This effectively requires firms to train/educate their employees on an ongoing basis because the requirement is effective on an ongoing basis.

105. One country in the insurance sector (Germany) indicated that although managers and responsible actuaries are required to have certain "qualifications," insurance agents and brokers are not. However, the German Insurance Association appears to have certain initiatives to impose minimum qualifications for anyone involved in the "intermediation process."

3. Regulatory requirements for the registration or licensing of individuals employed by a regulated financial firm

106. Most jurisdictions require that the financial firm itself be registered or licensed. In contrast, German insurance firms can engage in business without registering or otherwise being subject to any authorization process, although they must "notify" the *Gewerbeamt*.[28]

107. Only a few jurisdictions require that a firm's employees also be subject to specific regulatory requirements. For example, in the US and Japanese securities sectors, the employees of firms that sell financial products to the public must become "registered" representatives and pass examinations administered by SROs to test knowledge of

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[28] Office for Trade/Industry Affairs.

securities products and securities laws and regulations, including knowledge of customer protection rules and fair sales practices, and attend periodic training. This also appears to be the case in Canada (insurance and securities sector). In Italy, “financial salesmen” must meet certain integrity and educational requirements, and must pass a written and oral examination. In Australia (all three sectors), regulated financial firms and their staff that provide financial product advice to retail clients must meet minimum training standards relevant to the types of financial products with which they deal. In France, regulatory requirements for the registration of individuals exist for compliance officers, financial analysts and staff in charge of trading and clearing functions.

108. In the US insurance sector, life insurance “producers” (ie those who sell products) must pass required examinations and be licensed to sell the product being marketed before they can make specific product recommendations, sell products, or receive commissions for sales. Germany (BaFin) requires insurance firms to evaluate the qualifications of prospective brokers or agents that are to sell their products.

109. Otherwise, particularly in the **banking** sector, there is apparently no requirement for the employed individuals to be registered or licensed. However, the US banking regulators' guidance provides qualification, training and background clearance standards for personnel engaged in the direct bank sales of securities. US banking regulators expect that bank employees selling securities will receive training substantially equivalent to that required for personnel qualified to sell securities as registered representatives.

4. Product design

110. In general, it appears that countries do not have regulations that impose requirements on the product design process, particularly around retail products. With few exceptions, there are generally no restrictions on the design of new products.

111. In the US securities sector, the FINRA has issued guidance on product design for complex products.[29] In the UK (all sectors), the FSA’s approach is that it “expects” firms to ensure that products are soundly designed, even where manufacturers distribute solely or mainly through intermediaries. This derives from the FSA's "Treating Customers Fairly (TCF) initiative", which essentially means that , although the FSA does not *per se* regulate the design of financial products, it does expect firms to treat their customers fairly when considering the design of those products. One of the FSA's six TCF consumer outcomes is that products sold in retail market are designed to meet the needs of identified consumer groups and are targeted accordingly. It is not possible for the FSA to prescribe TCF in a way that applies to all firms, but it will typically cover issues such as the marketing strategy, developing product literature and the training implications, particularly for complex or new products.

112. In the majority of the insurance sector in the United States, the regulator reviews insurance products for compliance with applicable laws, including the requirement that the product meet actuarial standards.

[29] See Notice to Members 05-59, and the discussion at the bottom of page 5 concerning “reasonable basis suitability.”

5. Designation of an officer/unit in charge of compliance

113. Six jurisdictions require the designation of an officer/unit in charge of a compliance function, which would include any suitability requirements. In the US securities sector, NASD Rule 3013 and accompanying interpretive material requires members to designate a chief compliance officer (CCO) (see also NYSE Rule 342). Registered US investment advisers must also designate a CCO. US SRO rules in the securities sector also require broker-dealers to designate a principal executive responsible for compliance with rules and regulations of regulatory bodies. In the US banking sector, bank regulators require the designation by senior managers of specific individuals to exercise supervisory responsibility for the sale of non deposit investment products outlined in the bank's policies and procedures. Canada (securities sector) requires the designation of a CCO and imposes certain obligations on branch managers. In the European Union, MiFID requires all investment firms to establish and maintain a compliance function that monitors compliance with all firms' obligations under MiFID.[30] In Italy, before the transposition of MiFID, the "internal control function" was required to assume this responsibility. In terms of risk management, including risks posed by mis-selling, Japan requires financial firms in all three sectors to develop a compliance system for sales activities and explanatory obligation, including suitability and, as necessary, designate a compliance officer. France (banking sector) requires the compliance function to be monitored by an officer responsible for ensuring the coherence and effectiveness of controls of non-compliance risk.

114. The management boards in German insurance firms are required to supervise their sales forces (brokers, agents) on an ongoing basis. While in Australia there is no specific requirement to designate an officer/unit in charge of suitability requirements, there is a requirement for licensees that are intermediaries to nominate a "responsible officer" who is responsible for significant day-to-day business decisions about the provision of financial services by the licensee.

115. In the US insurance sector generally, it is not necessary for the firm to designate a person in charge of ensuring compliance with suitability obligations.

6. Evaluation of risks posed by mis-selling

116. Several jurisdictions have requirements in various sectors that require firms to have adequate risk management systems in place, which would extend to the evaluation of legal, reputational or other risks associated with mis-selling (Australia-all three sectors; US-banking and securities sectors; Italy-banking and securities sectors, Japan-all sectors; Switzerland-banking and securities sector). In the US securities sector firms are subject to sanctions if they fail to supervise reasonably a person subject to their supervision, and must establish, document and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities. MiFID also contains extensive requirements with regard to the risk management by firms.[31]

117 In the insurance sector in a majority of states in the United States, an insurer is required to establish a system to supervise recommendations in sales of annuities. The system must be reasonably designed to achieve compliance with the rule, including the drafting of written procedures, conducting periodic reviews of records, etc. However, the insurer may contract with a third party to establish the required supervision system.

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[30] Directive 2006/73/EC, Article 6.

[31] Directive 2006/73/EC, Article 7.

118. Other countries do not appear to have similar requirements, but view operational risk capital charges as effectively imposing such a requirement (French and Spanish banking sector).

7. Specific requirements with regard to the handling of customer complaints

119. A number of jurisdictions indicated that the required internal procedures as described above would be equally applicable to the handling of customer complaints (Australia-all sectors; Canada-securities sector; Switzerland-banking and securities sector). In addition, US SROs in the securities sector have specific requirements regarding the handling of customer complaints, *eg* firms are required to report customer complaints to the NASD and/or NYSE and to have specific written procedures regarding the review of correspondence to identify and handle customer complaints properly. Copies of all complaints and responses must be preserved and indexed by topic. In the US banking sector, a bank's compliance programmes should include a system to monitor customer complaints and their resolution. The Netherlands and Japan (all three sectors) impose specific requirements/guidelines to help ensure that consumer complaints are handled properly.

120. The MiFID implementing Directive on the other hand sets out the obligation for firms to establish, implement and maintain effective and transparent procedures for reasonable and prompt complaints handling as well as to keep a record of each complaint and the measures taken for its resolution.[32] The Consob (Italy) requires all intermediaries (1) to maintain an electronic registry of complaints; (2) to respond to such complaints in writing within 90 days; (3) to provide documents upon request to aggrieved customers; and (4) for the internal control function to provide twice a year the board of directors and board of auditors (and to the Consob) a report describing, for each service provided, the status of complaints, and any organisational and/or procedural shortcomings and proposals to remedy them.

121. Germany (insurance sector) indicated that the Insurance Contract Act will provide that an ombudsman service for out-of-court settlement of disputes between insurance intermediaries and policyholders in connection with the brokerage of insurance contracts can be authorised by the responsible ministries.

8. Heightened supervision of employees that have engaged in misconduct

122. The US and Canadian securities sectors, and the insurance sector in most of the United States impose heightened supervision on employees who have engaged in misconduct. In the Japanese securities sector, member firms of the Japan Securities Dealers Association (JSDA) must screen the background of prospective employees. If the applicant was a sales representative or employee of a JSDA member firm in the last 5 years, the member must check to see if the applicant was ever sanctioned by the JSDA.

123. Other jurisdictions require adequate internal monitoring of salespersons' activities (eg Consob), or prohibit persons convicted of crimes involving dishonesty or a breach of trust from serving at an insured bank (US banking sector).

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[32] Directive 2006/73/EC, Article 10.

9. Firm communication with clients/advertisements

124. Most countries have provisions governing communications and advertising. See answers under "Disclosure Requirements," above, which are applicable to firm communications with clients. In addition to disclosure requirements described in answer to question 2.3, Australia has in all three sectors extensive rules governing advertisements. For example, advertisements must refer to the Product Disclosure Statement, and cannot be misleading or be "bait" advertising. In the US securities sector, the NASD reviews advertisements prior to their first use. [33] In addition, copies of all communications must be preserved for not less than three years. US securities sector SRO rules also prohibit any untrue or false or misleading communication, or promises of specific results, exaggerated or unwarranted claims, opinions for which there is no reasonable basis or projections or forecasts of future events that are not clearly labelled as forecasts. Similar rules exist in the Canadian securities sector (IDA), the Spanish insurance and securities sectors, Italy (all sectors), the Swiss and US insurance sector (eg communications cannot be "misleading" and forecasts cannot be "unrealistic" and there cannot be omissions of material fact). The Japanese securities sector also has extensive rules. More detailed requirements concerning both advertisements and disclosure will come into effect with FIEL.

125. In the Spanish banking sector, the regulator must pre-approve statements by the bank concerning the costs or returns associated with a financial product. Swiss banks seem to be subject to certain "plain language" guidelines concerning communications.

126. MiFID requires all information to clients, including marketing communications, to be fair, clear and not misleading,[34] and sets out requirements that further specify this general principle at level 2.[35] Some jurisdictions such as France (AMF) may require that investment service providers send to the regulator marketing communications prior to their publication or distribution; regulators may require communications to be modified should they contain information that could be viewed as unclear or misleading.

127. US banking regulators' standards provide that advertisements and other promotional and sales material, written or otherwise, about non-deposit investment products sold to retail customers should conspicuously include minimum required disclosures. These materials may not suggest or convey any inaccurate or misleading impression about the nature of the product and must affirmatively disclose its lack of government insurance.

F. Other

1. Customer education requirements or authority programmes

128. It appears that no jurisdiction (whatever the sector) requires firms themselves to promote or engage in specific customer education. However, most regulatory authorities have customer education programmes.

129. For example, in the US securities sector, the US SEC created an Office of Investor Education and Advocacy (OIEA) that provides financial and investment educational materials to investors and assists investors as requested to understand securities laws, rules and regulations, and to receive complaints about investment fraud, market manipulation or the

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[33] NASD rule 2210

[34] Directive 2006/73/EC, Article 19(2).

[35] Directive 2006/73/EC, Article 27.

mishandling of their investments. NASD has a similar programme and has also created a foundation that provides financial support for innovative research and educational projects that provide investors with the tools they need to understand better the markets and the basic principles of saving and investing. Similar extensive programmes seem to exist in the Canadian securities and insurance sectors, in Japan in all three sectors, and in the Spanish securities sector. US insurance regulators in most states have outreach programmes that issue customer "alerts" regarding certain insurance products and services. France has recently created an institute (Institute for Public Financial Education) in charge of promoting investor education.

130. Other jurisdictions and sectors offer "informational materials" to educate consumers, either directly or via web sites (US banking sector; Italy-all three sectors; Australia-all three sectors; Netherlands-all three sectors; Spain-insurance and banking sectors, UK-all sectors).

131. Germany and Switzerland, in all sectors, appear to have no formal consumer education programmes in place.

2. Non-regulated products

132. Regulators were invited to identify any financial products that were available for sale in their jurisdictions, but which fell outside their regulatory ambit and were in their view potentially unsuitable for retail investors. Several examples were given in response. As they tend to be country-specific, we have not listed them here. However, it is clear that in many countries there exist unregulated (or less regulated) investment products that are functionally similar to 'regulated' ones, and which may pose equal or comparatively greater risks. Supervisors should consider this as they contemplate appropriate future regulatory steps or make recommendations to governments.

3. New regulatory initiatives relevant to suitability determinations

- The US NASD (securities sector) has a new rule, approved by the SEC on 7 September 2007, that sets forth broker-dealer obligations for purchases, exchanges and initial sub-account allocations of deferred variable annuities, which are classified as both securities and insurance products.
- The NYSE has a new rule that allows a member firm to recommend the securities of subsidiaries and sister entities subject to written disclosures.
- The Federal Reserve and the SEC have jointly adopted a rule implementing the bank exceptions from the definition of broker contained in the Gramm-Leach-Bliley Act, in consultation with other federal bank regulators. As adopted, Regulation R provides banks with a transitional exemption until the first day of their first fiscal year commencing after 30 September 2008. This will give banks time to make any necessary changes in their systems and compliance programs and should ensure that banks have time to come into compliance with the Exchange Act provisions relating to the broker definition. This exemption rule came into effect on the date that the Commission's previous order expired, 28 September 2007.
- The federal bank regulators are also in the process of reviewing their guidance on retail sales of non-deposit investment products to determine appropriate revisions in light of these legislative and regulatory changes.
- In Australia, changes to the regulation of financial services have recently come into operation which have an impact on the provision of personal advice. These changes include creating exceptions to the suitability requirement, removing the requirement for a Statement of Advice where the advice is not product-specific and there is no

conflict, or where the investment is less than a prescribed amount made by regulation. This amount is anticipated to be $15 000.

- The Canadian IDA and CSA are reviewing the entire client-adviser relationship and integrating all of the market's best practices into a new regulatory framework.
- In Germany, the IMD came into force as of 22 May 2007.
- In the UK, the "transposition" of MiFID and its implementing MiFID Directive (2006/73) will necessitate some changes to the UK's existing rules on customer suitability contained in the FSA's Conduct of Business rules (see description of MiFID rules above). Italy and France also noted that they are in the process of incorporating the MiFID directive and its implementing measures into domestic law.
- In France, within AMF's action for better regulation, the re-examination of its regulatory model included an in-depth, detailed consultation aimed at finding out what retail and professional investors actually expect from the regulator. In addition to the consultation, telephone polls and investor focus groups were set up. This resulted in several commitments taken to improve AMF's dialogue with retail investors. Among these are organising educational and training programmes, improving AMF's procedures to give retail investors a voice in financial regulation processes and encouraging institutions to use mediation services and improve coordination with the AMF's Ombudsman.
- Consob (Italy), has implemented a reform enacted in 2005 (Law no. 262/2005), which provides that the same rules of conduct apply to all financial products, regardless of their nature.
- In Japan, FIEL came into force as of 30 September 2007.
- In the Netherlands, the Act on Financial Supervision came into force on 1 Janury 2007.

4. Industry practice

133. A key part of this work is to understand what firms actually do to meet their suitability obligations and avoid mis-selling, including whether their activities vary by sector. We were particularly interested in how firms dealt with these issues where their business straddled more than one sector. Firms completed a questionnaire covering in particular: information obtained from the customer to make a suitability determination, disclosures made to the customer, the scope of the suitability determination and any exception or measures applying in specific situations. The questionnaire included questions about internal firm processes (training and remuneration of sales agents, record keeping, compliance review and internal control) as well as the existence of complaints handling mechanisms and marketing and advertising. Firms were also asked about how they deal with legal and reputational risks posed by mis-selling.

134. Firms were given the opportunity to answer to the questionnaire anonymously. As noted in the introduction, responses to the industry survey were received between the end of September 2006 and February 2007 and correspond to the practice in the firms at the time of the response. This may explain why in some instances the practice described in section 4 appear not to be in accordance with regulatory requirements described in section 3, which incorporate enacted legislation that had not yet entered into force at the time of the industry survey. This is particularly true in the case of a number of EU countries which are modifying their legal framework in order to implement the MiFID. The geographic coverage differs also slightly between the two surveys, in the sense that not all countries that are described in the regulatory survey are represented in the industry survey (see section A2 hereunder).

135. The working group defined the types and approximate number of firms to be included in the sample The group however recognised that due to the characteristics of the domestic markets, one or more categories may be less appropriate in some countries. The objective was to cover large multinational groups as well as smaller players. 32 of the 90 firms surveyed have more than one million retail customers or more than USD 100 billion of assets under management. 30 firms have more than 100 000 retail customers or more than USD 10 billion of assets under management (without belonging to the previous category), and 21 firms have less than 100 000 retail customers and less than 10 billion of assets under management. 7 firms did not provide information about the scale of their business. The working group has not tried to reach a fully representative sample, but nevertheless attempted to reflect the diversity of the market, while recognising that firms who participated might have better than average practice.

A. Composition of the sample

1. Activity of respondents

136. The survey included 90 firms in 10 countries and the findings of the report regarding industry practices may not necessarily represent practices in all countries in all sectors. The 90 firms in the sample included 19 asset managers and mutual fund houses, 32 banks or deposit taking institutions, 4 financial planners or investment advisers, 17 insurance companies and 18 investment firms or securities firms.

Table 2: Sample composition by type of firm

Main activity/licence of respondents	
Asset managers and mutual fund houses	19
Banks or deposit taking institutions	32
Financial planners/investment advisers	4
Insurance companies	17
Investment firms or securities firms	18
Total	*90*

137. Firms may conduct several activities and 52% of our 90 respondents declared at least one other financial activity. For instance, 25% of the 32 firms whose main activity is "bank" declared that they were also licensed as investment firms or securities firms. Conversely, 22% of the 18 firms who considered themselves as being primarily investment firms are also licensed as banks or deposit taking institutions[36]. Consequently, there is some overlap between categories. However, when considering only the four main activities listed in table 1 above, excepting financial planners, this overlap is limited to one third of firms. In other words, two thirds of the firms in the sample are purely banks, or investment firms, or asset managers, or insurance companies, without overlap between those four categories, even if some of them may have other activities such as financial planner or insurance broker, or be part of a larger financial group where other activities are conducted. In addition, even where activities overlap, the main activity declared by respondent appears to be the best element to take into account.

138. For this reason the present report will focus on the main activity. Unless otherwise specified, "asset managers", "banks", "financial planners", "insurance companies" and "investment firms" refer in this report to the firms who indicated in their response to the questionnaire that their main activity was respectively "asset manager or mutual fund house", "bank or deposit taking institution", "financial planner or investment adviser", "insurance company" and "investment firm of securities firm".

2. Geographic origin of respondents

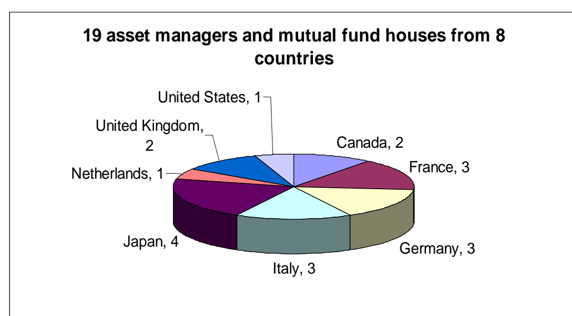
139. The respondents are from 10 different countries. The geographical coverage is as follows:

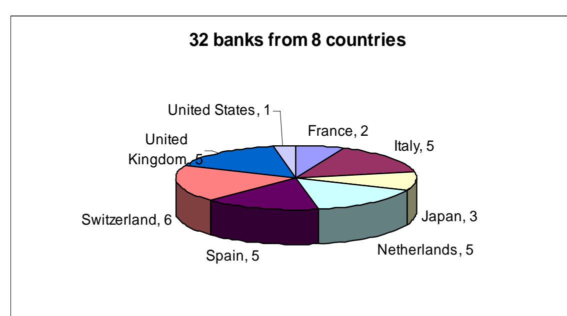
[36] Table 2 in Annex A describes in more details the other activities of firms

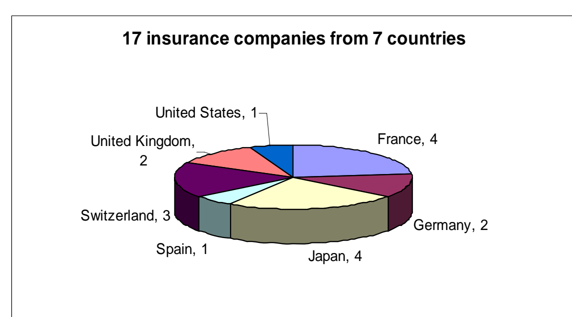
Table 3: Geographical coverage of the sample

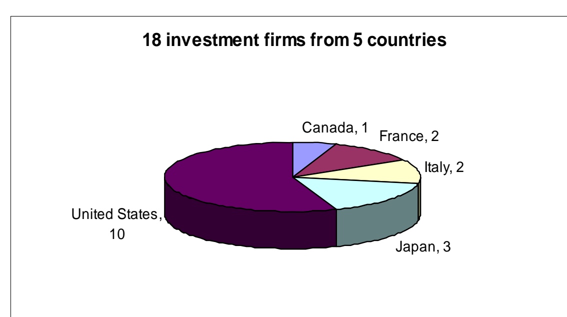
Country	Number of firms for each country
Canada	3
France	11
Germany	5
Italy	10
Japan	14
Netherlands	6
Spain	6
Switzerland	9
United Kingdom	13
United States	13
Total	*90*

Graph 1: Geographic origin of firms in each category









140. With the exception of financial planners, the sample is geographically balanced within each category: banks, asset managers and insurance companies who answered the survey came respectively from 7 or 8 different countries, and investment firms from 5 countries. Moreover, one country does not weight more than 25% of any given category of

firms, except for investment firms where the United States represent 56% of the sample with 10 firms.[37]

3. Retail network

141. 82% of respondents have their own retail network. However, the situation varies between categories. Nearly all banks and investment firms have their own network. This is the case for 76% of insurance companies, and 53% of asset managers.

142. 59% use third party sales agents: predominantly insurance companies and asset managers and to a lesser extent banks and investment firms. Among the sales agents used by insurance companies are banks and investment firms: two thirds of banks in our sample, and half of investment firms, sell for instance life insurance. The role of third party sales agents in the suitability determination is discussed in section 7 below.

143. While 94% of investment firms indicated that they offered their products and services to foreign customers, only 58% of asset managers, 41% of banks and 29% of insurance companies did.

4. Products and services offered

144. The range of products and services offered varies from one sector to the other (see Graph 2 and detailed figures in Table 18). Banks offer the widest variety of products and services, followed by investment firms[38]. Investment firms come first as regards riskier products and services, followed by banks: 78% of investment firms sell derivatives, the same proportion offer foreign products, 39% offer hedge funds, and 22% direct participation or limited partnerships.

145. A similar trend can be observed as regards less risky products, which are more frequently offered by banks than by investment firms: this is the case for government securities (81% against 56%), and not surprisingly for straight saving products (81% against 33%).

146. The range of products and services is more limited for asset managers and even more for insurance companies. For the latter category, the offer focuses on life insurance, variable insurance products, variable of fixed annuities and pension funds. Insurance companies appear less frequently than others to offer the most risky types of investment products: none of them mentioned derivatives or hedge funds and only 12% sell foreign products to their customers. However, the variety of underlying assets is probably wider for insurance companies.

147. Not surprisingly, asset managers rank first as regards the sale of funds of funds, of unit trusts and for discretionary portfolio management. One third mentioned hedge funds, 21% derivatives, and half sell foreign products and services.

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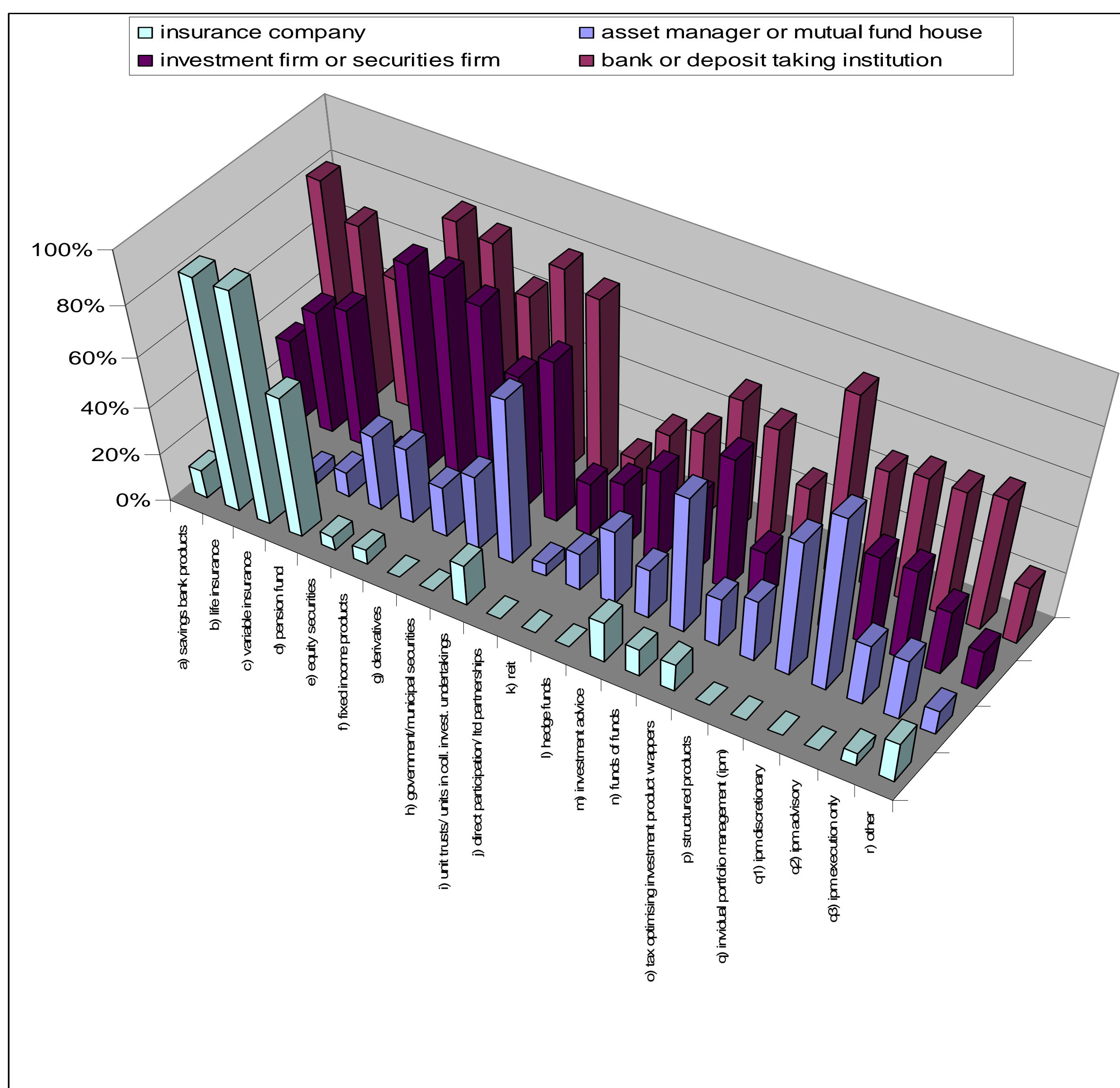
[37] Only one US firm responded as "bank" while other US holding companies responded as broker/dealer, asset manager or insurance company.

[38] Banks offer on average 56% of the 21 categories of products or services included in the questionnaire, against 43% for investment firms, 29% for asset managers and 17% for insurance companies

Graph 2: Products and services offered by each category



B. Analysis of responses

1. Definition of retail customer

a. "Natural person" appears to be an important distinction when defining retail:

148. In the firms' responses, the concept of "natural person" appears to be an important distinction when defining retail customers, and when asked for their definition of retail, a majority of firms referred to the concept of "non-institutional customer" (see Annex A, Graph 9). However, 23 % of respondents answered that there were cases where natural persons were not considered to be retail, for instance because of the customer's experience and understanding of the products, their portfolio size, the size of the transactions or a combination of these criteria. One firm uses exclusively another criterion, namely "persons whose account activities are directed by a third party investment advisor".

149. A clear difference appears between insurance companies[39] and the other sectors: insurance companies consider all natural persons to be retail customers without making distinctions between them.

Table 4: Cases where natural persons are considered non retail customers

	"non retail" natural persons	**customer experience**	**portfolio size**	**transaction size**	**cumula-tive criteria**
bank or deposit taking institution	38%	19%	28%	9%	9%
insurance company	0%	0%	0%	0%	0%
investment firm or securities firm	22%	11%	11%	0%	6%
asset managers or mutual funds	26%	21%	5%	5%	0%
Total	**23%**	**13%**	**13%**	**4%**	**4%**

150. A strong minority of banks considers some natural persons as non retail, in particular because of the size of the customer's portfolio, but also because of the customer experience, and/or the transaction size. This is particularly the case regarding Swiss banks (5 out of the 6 banks in our sample), and to a more limited extent to Spain and the Netherlands (2 out of 5 banks in both countries), with isolated examples in other countries (UK, Italy, US).

151. Eleven of the twelve firms who use the portfolio size to identify high net worth customers specified the amount of the threshold above which they do not consider customers to be retail. The amounts range between USD 100,000 and 5 million, with an average at 1,2 million. For 8 firms the amount is of USD 1 million or less, and 3 firms have a threshold between USD 2 and 5 million[40].

152. Firms were also asked whether, where the beneficiary of a personal assets holding vehicle would be considered a retail customer, they would also consider the vehicle itself a retail customer (unless it fulfills the usual conditions to be considered as non retail). Two thirds of investment firms answered yes, but only half of banks and asset managers, and one third of insurance companies.

2. Information collected from the customer

153. The suitability determination relies primarily on adequate information gathering by financial firms. Firms were asked what kind of information they requested from their customers, whether the information gathered varied according to customers, products or services, how the information was collected, and what policy was followed when the customer did not provide the information requested.

[39] The 4 financial planners from the United Kingdom, like insurance companies, consider all natural persons to be retail customers.

[40] 4 Swiss banks (average threshold USD 365,000), 2 investment firms, 1 asset manager and 1 bank from the United states (USD 2,1 million), 2 Spanish banks (USD 1,4 million), 2 Netherlands banks (USD 500,000 for the one who specified the threshold).

a. Overview of the information collected

154. When a recommendation is made, more than 95% of respondents collect information about: the age, investment experience, risk appetite of the customer and purpose of the investment.

155. More than 80% of respondents also collect information about the family situation, net worth and income of their customers, the type of assets they hold, their level of knowledge concerning financial products as well as their time horizon.

156. The tax status and the diversity of portfolio (78% each) are less frequently requested, as well as whether the investor needs a guarantee (68%), whether there is a gearing strategy (44%) or whether the investment is financed by credit (56%).

157. When no recommendation is made, the amount of information collected is, not surprisingly, significantly less. The investment experience, risk appetite and net worth of the customer, as well as the purpose of the investment remain the elements most frequently requested. The age of the customer is requested by nearly all respondents.

b. Sectoral differences as to the amount of information collected

158. With the exception of age, which is requested by all firms when a recommendation is made, there are differences between sectors (see Annex A, Graph 10). While they are not very significant regarding the purpose of the investment and income of the customer, for other information, a clear distinction appears. When making a recommendation, all banks, investment firms and asset managers ask for the investment experience and the risk appetite of their customer, and nearly all ask about net worth and level of knowledge. On the other hand, only 70% of insurance companies on average ask for the investment experience, level of knowledge and net worth of the customer, while 86% ask for his risk appetite. Only 21% of insurance companies enquire as to whether the investment is financed by credit, against nearly 80% of investment firms, 2/3 of banks and half of asset managers.

159. The question as to whether the investor needs a guarantee is asked by nearly all insurance companies, but only by 2/3 of banks and half of investment firms and asset managers. However, insurance companies rank last for all but 5 of the 16 categories of information identified in the questionnaire.

160. It should be noted that new legislation entered into force in Japan after the survey was conducted (see section on regulatory requirements). Readers should also bear in mind that for insurance companies, our sample was slightly more limited than for other firms, and covered 7 countries.

161. Another specific feature of insurance companies is that, for many categories of information, one quarter of them collects customer data only in some circumstances. While, as mentioned earlier, no insurance company excludes natural persons from the category of retail customers, some of them will however adapt the amount of information collected from the customer to the product. Banks on the contrary more frequently exclude sophisticated or high net worth customers from the category of retail customers, but will apply a more homogeneous policy to all their retail customers: less than 10% of them distinguish between customers, products or services as regards the information requested from customers to make a suitability determination.

162. The policy of asset managers is similar to banks in this regard. As we have seen earlier, one quarter of them identify customers that they will exclude from the retail category because of their experience, portfolio size or the size of the transaction, but the same policy is applied to all retail customers for the collect of information, with extremely rare exceptions.

c. How firms collect information from their customers

163. Firms like dealing with their customers face to face. 90 % of the firms surveyed collect information about their customer through an interview, and 77 % ask their customer to complete a form in addition to, or instead of, the interview. However, whereas all surveyed banks but one rely on interviews, only 59 % use forms. This is the opposite for investment firms and asset managers – nearly all of them ask for a form to be completed, but they rely slightly less on interviews. Forms completed by the customer are also widely used by insurance companies.

Table 5: Channels used by firms to collect information from their customers

	interview	form completed by the customer	information already available	other
bank or deposit taking institution	97%	59%	13%	13%
insurance company	88%	82%	18%	0%
investment firm or securities firm	83%	94%	11%	17%
asset managers or mutual funds	84%	95%	26%	0%
Total	**90%**	**77%**	**16%**	**8%**

d. Policy followed when the customer does not provide the information requested

164. The different sectors follow different policies when the customer does not provide the information mentioned above.[41] These policies need to be considered against the background of the amount of information requested.

165. As we have seen earlier, insurance companies request less information from their customers than other sectors. They mainly focus on the age and income of the customer, purpose and time horizon of the investment, as well as whether the investor needs a guarantee for his investment. However, half of them indicated that they would refuse the sale if the information is not provided, whatever the product or the type of information missing. An additional 18% would refuse the sale only when essential or compulsory information is missing.

166. Investment firms, who collect on average more information than insurance companies, have a more flexible policy. Almost all of them are ready to refuse a sale (or to open an account, or to make a recommendation) when information is missing, but one third would do so only for core information or information required by law or regulations,[42], and one fifth would refuse the sale only for higher risk products.[43] As an example of information requested by laws and regulation, a US investment firm mentioned that for municipal securities, the financial status, tax status and investment objectives, as well as any other information reasonable and necessary to recommend these securities, were required.

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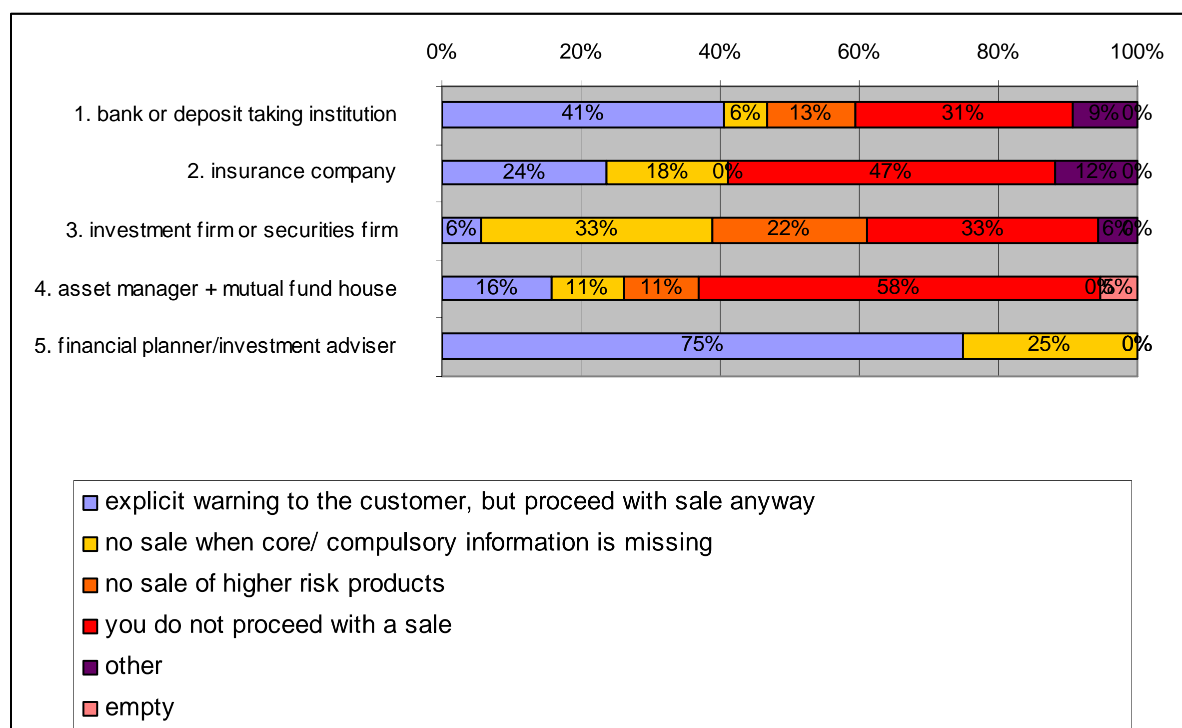
[41] See Graph 3. The responses proposed to firms in the questionnaire were “explicit warning to the customer, but proceed with the sale anyway”, “you do not proceed with a sale” and “other”. Firms were however invited to comment, and the two additional responses presented in the graph are derived from those comments.

[42] One investment firm takes also into account the channel used when deciding whether to refuse the sale or not.

[43] A US investment firm specified for instance that the firm does not make recommendations if legally required information is not provided, but that customer initiated trades are accepted, excluding options trading which requires suitability assessment whether or not trades are recommended.

Graph 3: Policy followed when the customer does not provide the information requested



167. Banks collect large amounts of information, but less frequently than others refuse to sell products when the information is missing. The 41% who proceed with the sale anyway would however explicitly warn the customer.

168. Asset managers frequently refuse the sale when information is missing. 58% do so no matter what information is missing or which product is sold. Only 16% would proceed with a sale after an explicit warning.

3. The suitability determination

169. Whereas banks are the category most frequently distinguishing between their customers at an early stage, excluding certain natural persons from the category of retail customers, and insurance companies are the category most frequently adapting the amount of information they collect, investment firms adapt their policy more frequently than other categories when making the suitability determination.

Table 6: Reasons for applying different suitability determinations

	Distinction as to the suitability determination	High net worth indivi-duals	Sophis-ticated investors	Other distinctions between retail customers	Different products or services
bank or deposit taking institution	44%	25%	25%	3%	47%
insurance company	41%	18%	6%	18%	41%
investment firm or securities firm	50%	44%	44%	33%	56%
asset managers or mutual funds	32%	16%	11%	16%	26%
Total	40%	24%	21%	14%	42%

170. However, for all categories, it is at this stage that distinctions are the most common. Even then, uniform policies remain the majority, with the exception of investment firms: 56% of them adapt the suitability determination according to the different products and services they offer.

4. Information provided or disclosed to customers

171. Firms were asked whether they were providing the following information to their customers:

- product characteristics
- whether the capital is guaranteed or not
- the investment risk
- the recommended investment duration
- the expected performance or kind of events affecting performance
- the information on commissions, fees and other costs directly borne by the customer (thereafter referred to as “direct costs”)
- the information on embedded costs indirectly borne by the customer (thereafter “indirect costs”)
- the amount and structure of other remuneration received by the firm for the sale (“other remuneration”)
- any conflict of interests

172. Firms were also provided with the opportunity to mention other types of information provided to customers. Only seven firms took this opportunity, mostly to qualify some of the elements mentioned above.

173. Firms were also asked whether they collected from investors an acknowledgement of receipt or of understanding, when the disclosure occurred, and what was the form of disclosure.

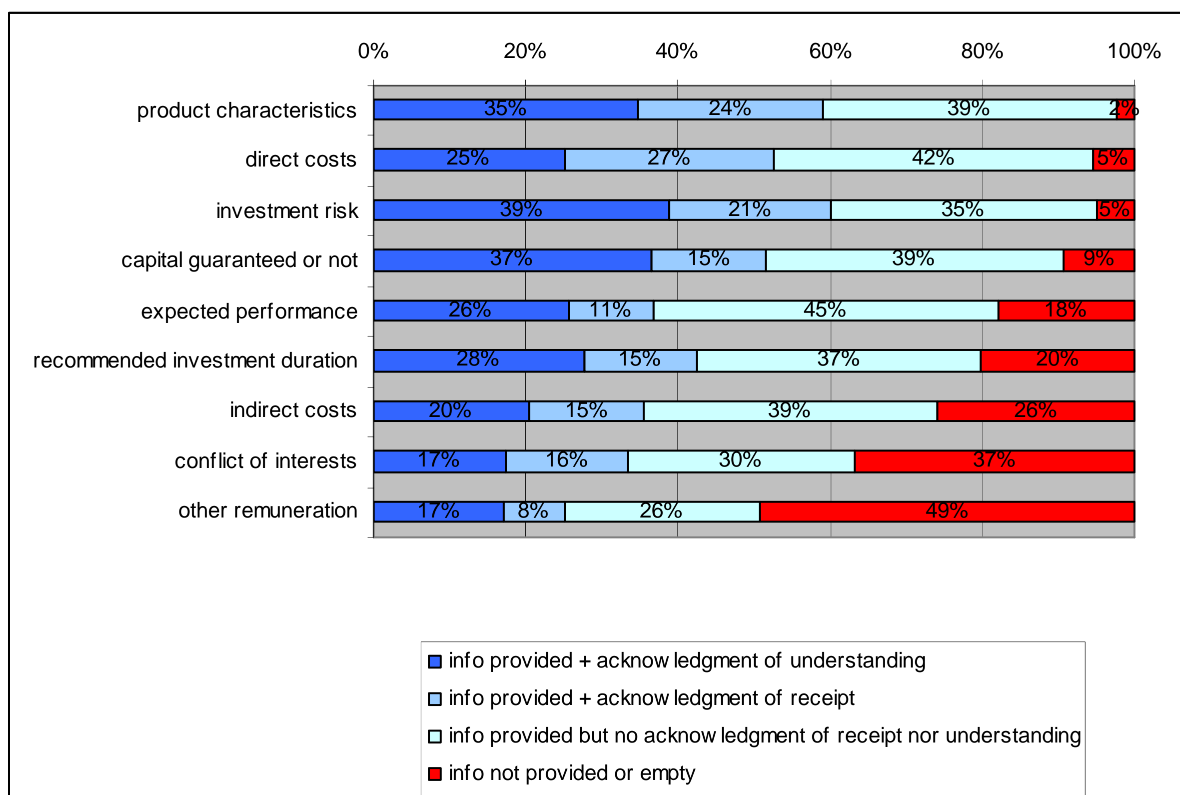
a. Nature of the information most frequently provided

174. We will first look at the various categories of information provided to customers (Graph 4). [44]

175. Not surprisingly, product characteristics and direct costs rank first and are provided to customers in almost all cases. Information about investment risks is also provided in 95% of cases, and the information as to whether the capital is guaranteed or not is disclosed in 91% of cases. The expected performance and recommended duration are also frequently provided. However, information on conflicts of interest, or that have a bearing on them (indirect costs and other remuneration), are less often provided.

[44] How to read this graph: for example, information on conflicts of interests is provided in 63% of cases (8+17+30), which could mean either that all firms provide information on conflicts of interests for two thirds of products, or that two thirds of firms provide information on conflicts of interests for all their products.

Graph 4: Information provided to customers – breakdown by category of information



176. Acknowledgments by clients of receipt or understanding of the information follow similar trends, but at much lower levels: all forms of acknowledgements taken together do not exceed 60% of cases, and the incidences of acknowledgements of understanding is always below 30%.

177. These trends are not completely uniform across products. For instance, whereas information about conflicts of interests is provided in less than 2/3 of cases, the incidence of this particular disclosure varies widely in respect of the products concerned. It is given in only 40% of cases for life insurance, but in 75% of cases in the sale of equities (Annex A, Graph 11).

178. Differences between categories are at their maximum for indirect costs (Annex A, Graph 12). These are provided by almost all investment firms and frequently by asset managers, but only provided by 60% of banks and insurance companies. The trend is similar concerning the disclosure of other remuneration received from third parties by the firm for the sale (Annex A, Graph 13). As regards conflicts of interests, banks, investment firms and asset managers have a similar profile (disclosure by two thirds of them, with acknowledgment by one third), whereas only one third of insurance companies provide this information. However when they do so, they almost always require an acknowledgment of receipt or understanding.

179. Taking for instance life insurance which is widely sold by banks, insurance companies and investment firms (see Annex A, Graph 18), insurance companies offer less information than other firms. This is the case primarily for 5 categories of information: the recommended investment duration, the direct costs, the indirect costs, the other remuneration and the conflict of interest. For these latter three categories, the difference could be explained by the fact that insurance companies sell an "in-house" product, with limited incidence of indirect costs, other remuneration and conflict of interests. On the contrary, banks and investment firms have to select an insurance provider, resulting in a

more complex fees structure, and with a heightened potential for conflicts of interests. The situation is nearly identical for variable insurance (See Annex A, Graph 19). Given the weight of these two products for insurance companies, this explains in part the lesser amount of information provided by this category.

180. A similar phenomenon can be observed for saving bank products, for which banks provide less information than investment firms. However, this is nearly exclusively due to information on indirect costs, other remuneration and conflicts of interests, which is in some cases less relevant, for example for the simplest types of saving bank accounts (see Annex A, Graph 17). However, when comparing the policy followed by banks and investment firms for other products, such as equity securities or derivatives (see Annex A, Graph 20 and Graph 21), the general trend mentioned earlier remains, and banks provide information slightly less frequently. There is however no difference between them as regards the provision of information on conflicts of interest for these products, even though banks less frequently provide more detailed information on indirect costs and other remuneration.

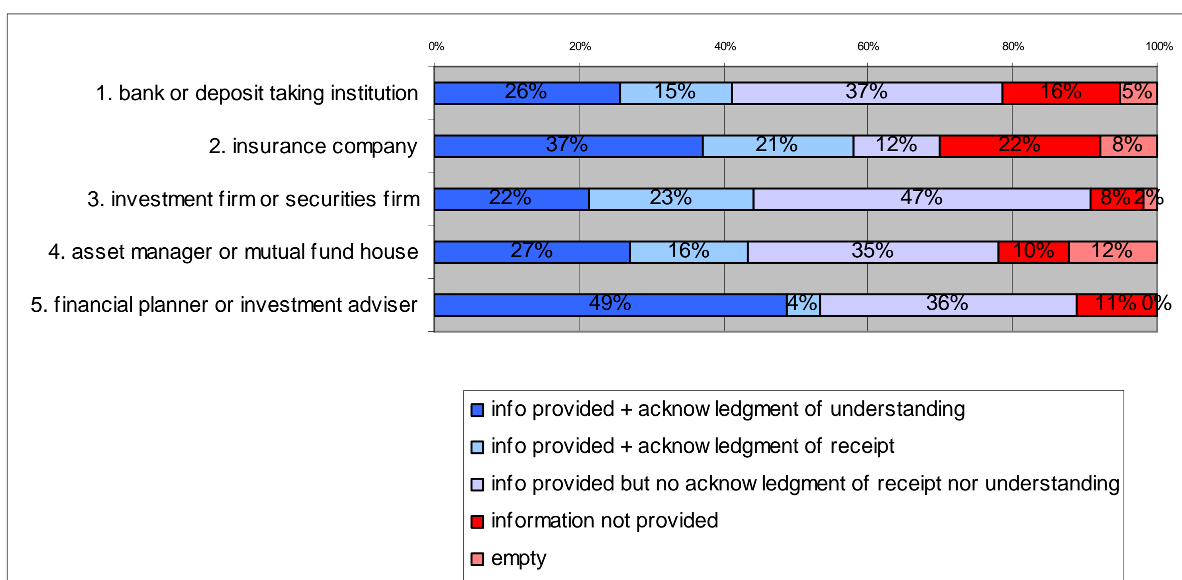
181. For hedge funds, the difference between banks and investment firms is even wider, across almost all categories of information, except the product characteristics, conflicts of interests and other remuneration, where there is little difference (see Annex A, Graph 22).

182. As regards discretionary individual portfolio management, banks and asset managers have a very similar disclosure policy, while investment firms provide slightly more information (see Annex A, Graph 23).

b. Sectoral analysis of the amount of information provided

183. When taking together the 9 categories of information listed above, investment firms are the category providing the most information, followed by banks and asset managers, insurance companies ranking last (Graph 5). The difference is however not very large: investment firms provide on average 90% of the information listed above for the product and services they offer, banks and asset managers approximately 80% and insurance companies 70%.

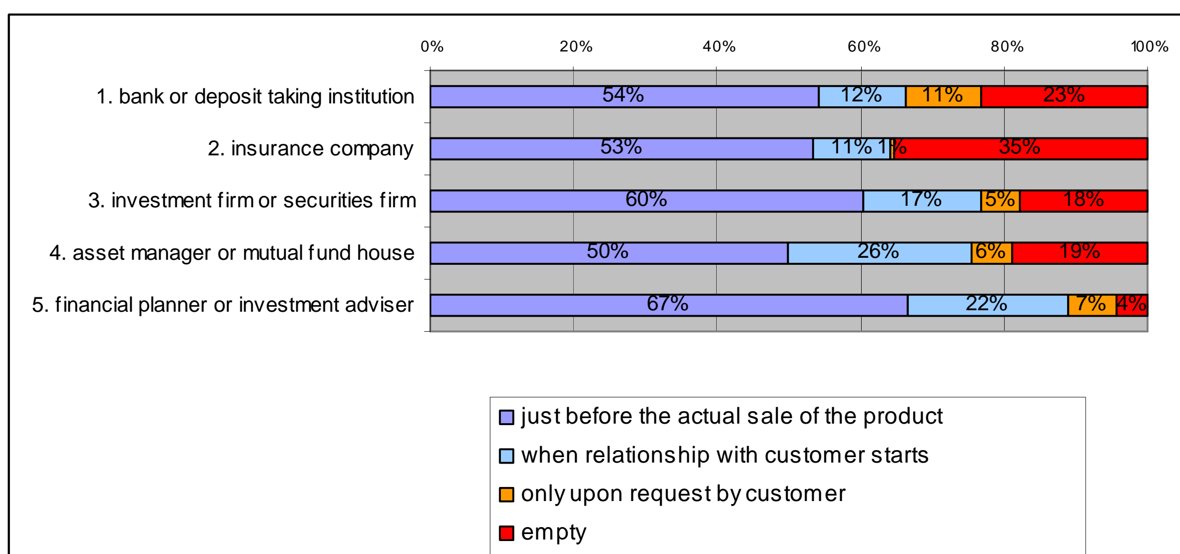
Graph 5: Information provided to customers and existence of an acknowledgement of receipt or understanding – breakdown by categories of firms



184. However, insurance companies are more likely to require more than others a formal acknowledgement of the information provided (in nearly 60% of cases, against slightly more than 40% for the other categories, excepting financial planners).

185. In order to assess the quality of disclosure, timing is also an element to take into account. This is shown in (Graph 6). This should be interpreted with caution, since the “right timing” depends in part on the nature of products or services sold.

Graph 6: Timing of the information provided – breakdown by firm type



c. *Form of disclosure*

186. Firms were asked how they disclosed the above mentioned information. They had the opportunity to mention several forms of disclosure for each category of information. Table 7 shows all the responses given. The category “other” was not frequently chosen, except for asset managers, and generally refers to use of websites, and sometimes to specific documents (such as fees and commission statements).

Table 7: Form of disclosure used by each category of firm – all responses

	contract	regulated disclosure document	summary or other written information	oral discussion with the customer	other	form not specified
bank or deposit taking institution	24%	37%	**47%**	42%	0%	9%
insurance company	15%	**59%**	11%	27%	6%	10%
investment firm or securities firm	15%	57%	**59%**	50%	5%	10%
asset managers or mutual funds	22%	**67%**	39%	22%	20%	0%
financial planner	3%	**78%**	45%	35%	0%	0%
Total	20%	50%	46%	39%	5%	7%

In bold: the most frequent form of disclosure for each firm type.

187. As one would anticipate, several forms of disclosure are used.

188. Banks less than others rely on regulated disclosure documents, which are the dominant form of disclosure for insurance companies, asset managers and financial planners.

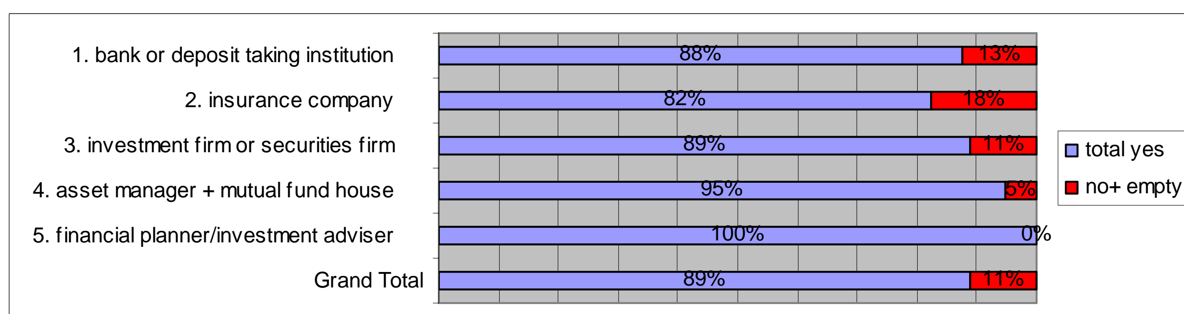
5. *Marketing and development of new products*

a. *Suitability in the marketing and advertising of financial products*

189. The vast majority of firms consider regulatory requirements concerning suitability when developing the marketing or advertising of financial products to retail customers, and there are no significant differences between sectors in that regard (Graph 7). Only seven firms[45] explicitly answered "no" to the question and four additional firms did not respond. Out of these eleven firms, two specified that the reason was because they do not advertise for individual products. One Dutch bank explained that they provided execution services only. Two firms who did not specify the reasons for their response are specialised in high net worth individuals. [46]

190. Among those who take suitability into account at this stage, several asset managers, investment firms and banks mentioned in their comments that the advertising material had to be approved by the compliance function and/or the legal department. [47] Insurance companies did not refer to their approval process, and the insurance companies who commented focused rather on the fact that the material should target the appropriate customers, or emphasized the need to provide clear, non misleading information. Targeting the appropriate segment and providing clear information is however not specific to this category and was also mentioned by other sectors. [48] In their comments, banks and investment firms mention in a few instances the need to inform or warn explicitly about the product risks, or the need to balance expected performance and risks. [49]

Graph 7: Considering suitability in the marketing and development of new products



191. Firms were asked about their product design process. They were asked in particular whether they took into account legal and reputational risks and potential conflicts of interest at the product design stage. Almost all firms across all sectors equally take into account legal and reputation risks in the design or approval process of new products (Table 8). Four of the six firms who do not consider these factors or did not answer explained that they were not designing products, but selling products designed by others. However, several other firms

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[45] Three banks, two insurance companies and two investment firms.

[46] One Swiss insurance company and one Italian asset manager.

[47] Compliance department approval in 14 firms (6 asset managers, 4 investment firms, 3 banks and 1 financial planner). Legal department approval in 9 firms (5 asset managers, 2 banks, 2 investment firms).

[48] Targeting the appropriate segment: 4 banks (Spain, Switzerland, United K), 3 insurance companies (UK, Germany), 1 UK asset manager, 1 UK financial planner. Providing clear/factual/non misleading information: 3 insurance companies (Japan, US), 3 asset managers (Italy, Germany), 2 investment firms (US, UK), 1 bank (France).

[49] 4 banks (France, Spain, Switzerland), 2 US investment firms, 1 French asset manager.

who are in the same situation specified that they do take these factors into account when selecting the products.

Table 8: Factors taken into account in the design and approval process of a new product

	Legal and reputation risks	Potential conflicts of interest	Other
bank or deposit taking institution	94%	91%	62%
insurance company	94%	65%	18%
investment firm or securities firm	94%	89%	67%
asset managers or mutual funds	95%	89%	63%
financial planner	75%	75%	25%
Total	93%	84%	53%

192. Similarly to what had been observed for the disclosure policy, differences across firm categories are more significant as regards potential conflicts of interests. While approximately 90% of banks, investment firms and asset managers take this factor into account in the approval process, only two thirds of insurance companies do so.

193. Many firms advised that their design and approval process took into account factors beyond the two mentioned above. Ten firms mentioned that they took into account other risks, including risks for customers. Eight indicated in particular that they were making sure that the product was coherent with the needs of the targeted customers. A Swiss bank described in more detail that they were assessing the need for "specific risk warnings, disclosures, limitations to specific client segments, requirements for independent controls".

194. Although no specific question was asked on this aspect, one third of banks and investment firms mentioned spontaneously in their comments the existence of a specific committee (7 firms[50]), the necessity of an approval by the compliance function (3 firms[51]), or the existence of a formal approval process (10 firms) and the various departments involved in this process (including the legal department). Most insurance companies did not give any details about their design or approval process.

6. Compliance

195. Firms were asked about the existence and independence of a compliance officer, as well as its role concerning suitability requirements, about the training and compensation of sales agents, the record keeping policy, and the various procedures in place to monitor compliance as regards customer suitability.

a. *Compliance group or officer*

196. All banks but two, as well as all investment firms and asset managers, have a specific compliance group or officer responsible for ensuring compliance with all applicable suitability requirements (see Table 9). Only two thirds of insurance companies do.

[50] 2 banks (France, Spain), 3 US investment firms, 2 asset managers (France, Netherlands)

[51] 2 French firms (asset manager and investment firm), 1 US bank

Table 9: Existence and independence of a compliance group or officer in charge of suitability

	Compliance group or officer exists	Efforts made to ensure its independence
bank or deposit taking institution	94%	78%
insurance company	65%	65%
investment firm or securities firm	100%	94%
asset managers or mutual funds	100%	100%
financial planner	100%	100%
Total	91%	84%

197. Concerning the two banks who provided a negative answer, one mentioned that they were currently creating a compliance function, and one provided no explanation but mentioned in another question that compliance risk was assessed through “self control assessment”.

198. The five insurance companies who answered negatively and the insurance company who did not respond to this question did not provide any explanation. These six firms come from four different countries.

199. It should be noted we have considered as a positive answer, cases where the compliance function was provided by the internal audit department (2 banks and one investment firm), by the legal department (1 bank and 1 insurance company), or by dedicated groups or managers within business units (2 banks).

200. Almost all the firms who have a compliance group or officer considered that they were making efforts to guarantee its independence.

201. Firms were asked about the responsibilities of their compliance group or officer concerning suitability. They frequently responded in very broad terms, such as “adherence to laws and regulations” or to monitoring internal procedures and other standards. Banks provided slightly greater detail.

Table 10: Responsibilities of the compliance group or officer

	approval of new products/ documenta tion	approval of marketing/ advertising material	review of transactions/ recommenda tions	draft/ update procedures	Provi-de advi-ce	provide training
bank or deposit taking institution	6	2	4	5	1	2
insurance company	2		2	1	1	1
investment firm or securities firm	1		3		3	1
asset managers or mutual funds	3		2			
financial planner			2			
Total	12	3	13	6	5	4

*This chart provides for six responsibilities **the number of firms** of each category who mentioned them as being part of the tasks performed by the compliance function.*

202. The responsibilities most frequently mentioned are the review of a sample of transactions, or of recommendations made, as well as the approval of new products, including product documentation (See Table 10). Updating processes and procedures, as well as providing advice and training are evoked in a few cases.

b. Training of sales force

203. All firms provide compliance training to their sales agents and advisors, with the exception of two banks, one investment firm and one mutual fund who explained that they do not have sales agents or advisors, as well as one insurance company and one asset manager who did not comment on their response (Table 11). Suitability is also almost always included in the training, with however 10 additional exceptions, particularly among asset managers. The reasons given are here again the absence in the firm of a retail network of its own, but also the fact that no advice is given to customers, [52] in one case because they are all considered to be qualified investors. One insurance company explained that it provides "legal training", and could have been added to the 82% of firms who mentioned suitability training, which would raise the figure to 88%.

204. The sale of specific products is very frequently limited to specifically trained sales agents or advisers, with the exception of asset managers.

205. A vast majority of firms also seek to verify that the sale agents or advisers understand compliance training and the products they offer, asset managers being again below the level of other firms. The absence of a retail network within the firm itself, which is frequent feature for asset managers, is here again the most frequent explanation given.

Table 11: Training provided to sales agents or advisers

	Compliance training provided	Suitability is part of the training	Sale of specific products limited to specifically trained sale agents/ advisers	Verification that agents understand compliance training and products offered
bank or deposit taking institution	94%	88%	84%	84%
insurance company	94%	82%	82%	76%
investment firm or securities firm	94%	94%	78%	89%
asset managers or mutual funds	89%	63%	47%	68%
financial planner	100%	100%	100%	100%
Total	93%	83%	76%	81%

c. Compensation policy

206. Conflicts of interests could arise when sales agents have financial incentives to recommend certain products rather than others. Firms were asked whether the amount of compensation was independent from the product and whether compensation is tied to compliance. Some firms apply both measures. In order to better describe the various policies, Table 12 describes in the first column only those applying exclusively a policy where the amount is independent from the product, and in the second column firms in which the only policy is to tie compensation to compliance, whereas the third column includes firms combining both policies. The last column gives the total of firms applying either policy, or both.

[52] Two UK asset managers.

Table 12: Compensation of sales agents and advisers

	Amount independent from product	Compensation is tied to compliance	Combination of both policy	Total of firms taking into account compliance in their incentive policy
bank or deposit taking institution	22%	9%	28%	59%
insurance company	18%	24%	12%	53%
investment firm or securities firm	11%	28%	17%	56%
asset managers or mutual funds	21%	0%	42%	63%
financial planner	25%	25%	0%	50%
Total	19%	14%	24%	58%

207. There are no major differences between sectors when considering the total of firms taking into account compliance in their incentive policy, be it in one way or another. However, the "policy mix" used varies significantly. Asset managers who take into account suitability in their compensation policy use frequently a combination of both measures (2/3 of cases), or exclusively keep the compensation independent from the product. Banks' favoured policy is also to keep the compensation independent from the product.

208. On the contrary, investment firms and insurance companies prefer more frequently to tie compensation to compliance rather than adopting a "product neutral" compensation policy.

d. Record keeping

209. There is a widespread practice across sectors to keep record of any activity undertaken within the framework of the suitability appraisal as well as of information provided to customers and approval of new products.

210. A cross-sector analysis shows that in the insurance industry such practices are less widespread. In particular, whereas the approval process of new products is formalised and recorded in almost all cases in the banking and securities sectors; in the insurance sector this happens only in slightly more than 50%. This is the same concerning record keeping of the suitability determination.

Table 13: Record keeping

	Suitability determination	Information obtained from customer	Information provided to customers	New product approval process	Training received by sale agents
bank or deposit taking institution	84%	94%	88%	91%	84%
insurance company	41%	88%	82%	59%	88%
investment firm or securities firm	83%	100%	94%	94%	94%
asset managers or mutual funds	89%	100%	95%	100%	79%
financial planner	100%	100%	100%	100%	100%
Total	78%	96%	90%	88%	87%

e. Monitoring compliance

211. Having a range of compliance measures in place is beneficial in avoiding risk. However, it is important to monitor compliance. We asked firms about their use of a range of monitoring tasks.

212. The three procedures most frequently mentioned by respondents to monitor compliance with the suitability policy when a recommendation is made are:

- the analysis of customer complaints (3/4 of firms),
- compliance testing (2/3)
- and the second review process (half of respondents).

213. There are significant differences across sectors: compliance testing is quoted by 83 % of investment or securities firms and 72 % of banks, but only by 53 % of asset managers/mutual fund houses and 25 % of insurance companies (see Annex A, Graph 24).

214. Insurance companies use nearly all techniques less than other sectors, with the exception of the analysis of customer complaints and client satisfaction surveys, which appear to be their favourite tools. Each of the other methods are used by less than 30% of them.

215. Investment firms predominantly use compliance testing and the analysis of customer complaints (83% each), automated monitoring systems (72%). Second review processes and exception procedures are also widely used (2/3 of investment firms each).

216. Banks use the analysis of customer complaints (78%), compliance testing (72%) and client satisfaction surveys (69%).

f. Assessing suitability risks

217. Firms were asked whether product suitability was included in their compliance risk assessments (eg evaluate inherent risk exposures and applicable risk management and controls).

218. Around 70% of all the firms which have been interviewed take into account risks related with suitability requirements within compliance risk management, without any major difference between sectors: 78% of investment firms at the maximum against 68% of asset managers at the minimum. It is noted that a percentage slightly below 30% of firms do not assess such risks.

219. Answers show the existence of a legal requirement in a very limited number of cases, with the exception of financial planners: in the banking and securities sectors this situation may change in the near future as a result of the implementation of Basel II and of Mifid in the EU.

7. The sharing of responsibilities between firms

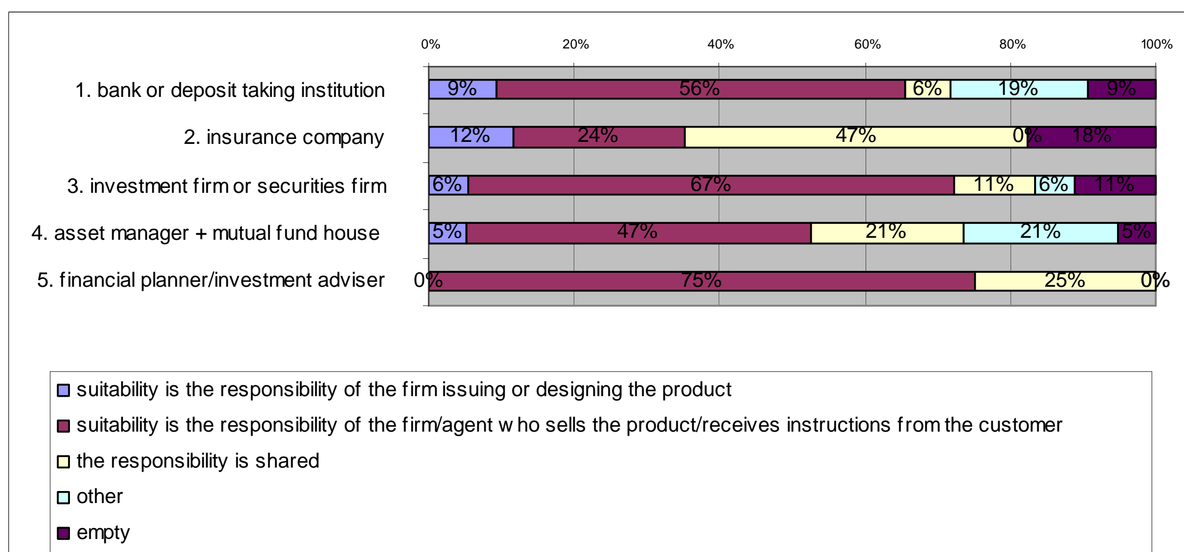
220. As we have seen earlier, 59% of respondents use third party sale agents: Firms were asked to describe the respective responsibilities concerning suitability.

221. As a general rule across the sectors, suitability tends to be the responsibility of the firm/agent who sells the product or receives instructions from the customer.

222. However, in the insurance sector, which frequently uses third party sales agents, responsibility is shared to a large extent between the product provider and the third party agent. Some insurers explained that the sale of insurance products was done under their responsibility. Others considered that the responsibility of the designer was to provide appropriate information on its products to the third party, in particular for which types of

customers the product would be suitable, but that it was for the third party to make a recommendation to the customer.

Graph 8: Sharing of responsibilities between the firm and third party sale agents



223. Sharing of responsibility is also frequent, albeit to a lesser extent, among asset managers, who rely frequently on third parties, whereas there is very little sharing of responsibility in the banking sector. In this latter sector, some jurisdictions emphasise a split between the product provider ensuring that its marketing material/product specifications are appropriate for the mass market and the third party agent ensuring the product is suitable for the specific customer.

224. For investment firms, suitability is largely the responsibility of the firm/agent who sells the product or receives instructions. That third party will typically have "Know Your Customer" obligations or other specific responsibilities under Broker Dealer Selling Agreements. However, in most jurisdictions, this will depend on: (i) whether the agent is making a recommendation and (ii) the type of product/service (eg execution-only dealing) involved.

8. Use of internet

225. With the exception of investment firms and banks, there are, generally, no specific suitability measures in place for sales of products through the Internet. In investment firms, internet selling is generally accompanied by strict supervision eg risk warnings to customers and, in some jurisdictions, applicable rules generally apply where the sale is actually solicited by the customer (so-called "client entered trades" or "customer self-directed transactions"). In some jurisdictions, internet sales are specifically monitored by the investment firm compliance departments.

226. The overwhelming trend is for asset managers not to sell products through the Internet to retail customers, but to rely on third parties instead. Those third parties remain responsible for ensuring suitability if they sell products on-line. In some jurisdictions, only mutual funds that match with client classification and certain types of collective investment scheme can be bought on-line.

Table 14: Sale of financial products through the internet – specific measures in place regarding customer suitability

	yes	no	N.A.
bank or deposit taking institution	50%	44%	6%
insurance company	12%	47%	41%
investment firm or securities firm	50%	33%	17%
asset managers or mutual funds	26%	47%	26%
financial planner	0%	50%	50%
Total	36%	43%	21%

227. In the banking sector, internet selling does occur but tends to be (i) low in value and volume, (ii) generally carried out on an execution-only basis and (iii) subject to strict controls (particularly in the case of high-risk products). These controls include, in some jurisdictions, a total prohibition on high-risk products being sold on-line or a requirement that: (i) a warning be given to the customer before any sale and that (ii) the customer sign a notice recognising that he/she has understood the high-risk nature of the product.

228. As a general rule, there is very little internet selling in the insurance sector, and only for simple products that do not require much explanation and which are sold on a Direct Offer/Execution-only basis. In the latter case, suitability is generally only checked against objective, rather than subjective, criteria. Customers are directed to seek financial advice if they are unsure about a product.

9. Updating information

229. Client circumstances change over time. All the asset management and investment firms interviewed have an update policy and actively seek updates from customers on their circumstances, but the majority of mutual fund houses interviewed have no update policy. The tendency for them is to seek customer updates from trade/contact records. In the case of asset managers, the updating of a client's profile varies from jurisdiction to jurisdiction, ranging from minimal updating of at least once a year to occasional *ad hoc* updating through client interviews and in some cases, to regular updating through client meetings with sales partners.

Table 15: Updating information

	you actively seek updates	you rely on clients volunteering updated information	no update policy	empty	Grand Total
bank or deposit taking institution	75%	6%	13%	6%	100%
insurance company	47%	18%	18%	18%	100%
investment firm or securities firm	67%	33%	0%	0%	100%
asset managers or mutual funds	74%	16%	11%	0%	100%
financial planner	50%	25%	25%	0%	100%
Total	67%	17%	11%	6%	100%

230. Banks generally do not rely on clients volunteering information about their personal circumstances, but instead regularly seek updates. The responses suggest that there is

significant customer relationship management occurring in the banking sector with firms carrying out periodical interviews or regular updating through data management/client relationship management systems.

231. In the insurance sector, the general trend is to rely on *ad hoc* information offered by the customer and to update fact-find documents at review meetings or on special occasions related to particular changes in the customer's personal circumstances. Periodic visits are carried out in a few jurisdictions.

232. Investment firms surveyed always had an update policy. They generally actively seek updates and have on-going "Know Your Customer" obligations. However more frequently than for other sectors, they place the onus on the customer to volunteer information (such as a material change in his/her financial/employment situation) in order to update his/her profile, even though this is not true in all countries surveyed, such as in the United States, where broker-dealers are required to update customer information (under books and records rules) no less than every 36 months. In certain jurisdictions, the burden to ask the customer for updates may be transferred to the selling agent where the agent makes a specific recommendation to the client.

10. Dispute settling mechanisms

233. Firms were asked whether they provided an out-of-court procedure to settle disputes regarding customer suitability (eg an ombudsman).

Table 16: Existence of dispute settling mechanisms

	yes, external ombudsman	yes, firm s ombudsman	yes, other	no	empty	Grand Total
bank or deposit taking institution	50%	16%	31%	3%	0%	100%
insurance company	53%	18%	6%	12%	12%	100%
investment firm or securities firm	11%	6%	61%	22%	0%	100%
asset managers or mutual funds	16%	5%	37%	42%	0%	100%
financial planner	100%	0%	0%	0%	0%	100%
Total	38%	11%	32%	17%	2%	100%

234. All banks but one use some form of dispute settling mechanisms. The customer is typically referred to an out-of-court dispute resolution procedure such as a specialised external ombudsman provided either by a state regulator or sponsored by an industry trade association. The customer is then expected to contact that ombudsman directly.

235. In some jurisdictions, the normal procedure is that the customer must first exhaust the firms' internal redress mechanism (ie the complaints/claims/"quality relations" department) before the firm refers the customer to an external ombudsman.

236. Certain jurisdictions have a financial limit (eg €50,000) on claims that can be referred to the ombudsman.

237. For asset managers the general, but not overwhelming, tendency is to rely on internal dispute resolution procedures/internal complaints policy rather than to refer customers to a specific out-of-court dispute resolution procedure. Most firms have defined claims management procedures established by a self-regulatory association.

238. Most insurance companies direct customers either to an independent/trade association-sponsored insurance ombudsman/arbitration board or a State insurance regulator. Some jurisdictions have a separate ombudsman/arbitration board for life/non-life products;

239. As regards investment firms, there is a greater tendency to rely on arbitration/mediation procedures through a self-regulatory organisation sponsored arbitration forum, typically following exhaustion of internal redress procedures eg an internal complaints department/"Early Dispute Resolution" department or a dedicated Client Services representative team. Securities firms often choose to enter into pre-dispute arbitration agreements with their customers, and customers generally sign these agreements as a condition to opening brokerage accounts. In addition, in the US securities sector, firms may be required under SRO rules to arbitrate disputes at the customer's election, even in the absence of a pre-dispute arbitration agreement.

C. Conclusions on industry practice

240. Significant differences appear between the practices of banks, investment firms and asset managers on the one hand, and insurance firms on the other. In particular, the former collect comparatively more information from their customers before making a recommendation.

241. For example, many insurance companies do not seek information about a customer's assets or investment objectives or, if relevant, ascertain whether the investor has a credible "gearing" strategy, ie how borrowed monies are to be used to finance purchases. In a significant minority of cases, insurance companies do not ask about the risk tolerance of their customers. This may be because, in part, insurance companies have a more narrow interest, ie only whether the investor seeks a "guarantee" or not. That being said, it appears that insurance firms are more prepared to refuse a sale if they do not receive what limited information they seek. It is also interesting to note that insurance companies' policies, regarding what information they will obtain from retail investors, frequently differs depending on the type of product being sold.

242. As they collect less information on the investment experience and level of knowledge of their customers, insurance companies are less in a position to adapt their suitability policy to the specific situation of their customers. Consequently, they generally do not distinguish between retail and "sophisticated" investors.

243. Insurance companies also tend to disclose less to their retail customers concerning their products. In this regard, it is noteworthy that little information is disclosed concerning conflicts of interest.

244. Regarding the compliance framework at insurance companies, only two thirds of them have an independent compliance group or officer in charge of suitability; their monitoring system appears less comprehensive; and their record keeping less rigorous.

245. The suitability policy of banks, asset managers and investment firms seems to be more robust, reflecting more demanding regulatory requirements. However, the risks are also higher, as they more frequently tend to sell higher risk products. In some jurisdictions, this may also include interests in hedge funds and other complex products.

246. Finally, as part of our survey, we sought to determine whether practices vary between firms depending on the products they sell. In particular, we wanted to determine whether firms selling higher risk products have a more comprehensive and robust suitability

policy. To this end, we checked whether firms offering investment in hedge funds and/or investment in direct participation programs or limited partnerships (hereafter "higher risk products") applied a different policy than firms that do not offer such products. As no insurance company in our sample offers such products, the analysis does not include this sector.

247. The answers to the industry survey suggest that investment firms and asset managers who offer higher risk products tend to have a more sophisticated and robust suitability policy, and distinguish much more frequently between different categories of products or services: 62% of investment firms and 67% of asset managers who offer higher risk products have a different suitability policy depending on the products they offer, against respectively 40% or the investment firms and 8% of the asset managers who do not offer such products. Asset managers with higher risk products also distinguish more frequently high net worth or sophisticated investors. (See table 20 in Annex A).

248. Banks offering higher risk products generally do not apply a different suitability standard dependent upon the nature of the offered products. There is one standard for all retail customers no matter what they buy. Instead, banks will often consider a customer, who is a natural person, as "non-retail," because of his/her experience, or because of the portfolio size or transaction, and therefore apply a suitability standard that is different than that applied to the retail customer. Nonetheless, banks that offer higher risk products also tend to have more robust suitability and disclosure practices than those that do not offer such products. For example, banks offering such products generally more frequently use forms completed by the customer (in addition to an interview[53]) to collect information from their customers; they more frequently take into account suitability requirements when developing marketing and advertising for new products; they always have a specific compliance officer, always give their sales agents or advisers compliance training and have a better record keeping policy. The difference between the practices of banks that sell high risk products and those that do not, however, is not always significant. Indeed, banks and investment firms offering higher risk products appear to less frequently take compliance into account in their compensation policy.

249. The results of our survey suggest that practices could be improved in some firms in the areas of disclosure and collection of information. Some important steps would include the following:

- Collecting more information from customers regarding their investment strategy, including the risks involved in borrowing money to finance the purchase of investments (gearing strategy), and taking this into consideration before recommending a product to a retail customer.
- Seeking to address conflicts of interest by disclosure and other means. In this regard, mere independence of the compliance function may be insufficient by itself.
- Aligning the remuneration policy of sales agents and advisors with regulatory suitability and disclosure requirements, and related internal policies.

[53] We do not, however, wish to imply that verbal or face-to-face interviews are not important. Indeed, interviews may frequently elicit more important and useful information than a mere form.

5. Conclusion

250. Our review indicates that while suitability and the risks posed by mis-selling are increasingly on the minds of regulators and firms, there remains wide disparity in what is required of firms and in firms' internal policies and practices.

251. Individuals in many jurisdictions are forced to take greater personal financial responsibility as reliance on the state and employers for retirement/pension benefits decreases. The need for financial advice and recommendations will therefore continue to increase. As customers look for better returns and as firms continue to innovate, the complexity of financial products is also likely to increase. The coincidence of these trends should not be lost on regulators or firms – consumers will need to be able to rely on good advice about products that are suitable for them, with conflicts of interest, if not avoided, clearly disclosed.

252. Where the economic characteristics of a product are similar, there seems no reason for the rules governing its sale to differ substantially, simply based on whether it is sold in the banking, insurance or securities sector. That is not to say that countries need to change the design of their regulatory system. It is possible to have consistent (or at least similar) suitability and disclosure standards for the sale of similar financial products in the three sectors. Consistency of regulation at the highest possible standard is the important factor, not whether the system is sectoral or twin-peaks. [54] Such consistency requires an appropriate level of cooperation across sectoral regulators and a commitment to high standards.

253. Inconsistency of sales requirements between sectors for the same products may result in regulatory arbitrage. That is, firms may design their products in such a way as to avoid the highest regulatory standards. This is undesirable for the regulatory systems and for consumers. Perhaps even worse is where there are 'financial based' products that escape regulation altogether. Several supervisors raised this as an issue and it is one which governments should consider. As well as potential harm to investors, there is a potential penalty on firms that operate in the most regulated sectors.

254. The survey results indicate that firms take their suitability and disclosure obligations seriously. Matters such as compliance, supervision and training of employees appear to be high priorities. In the insurance sector, however, we noted gaps in disclosure of conflicts, particularly around remuneration. Similarly, we believe regulators and firms across all sectors could improve rules and practices regarding how sales agents are remunerated. In other words, firms should consider the implementation of a remuneration system that rewards those who make substantial efforts to comply, and do comply with the highest suitability and disclosure standards.

---

[54] The term often used to describe a split between conduct and prudential regulation, as in Australia and the Netherlands.

Annex A: Industry survey

Table 17: Other activities of respondents

main activity	other activity	
asset manager or mutual fund house	no other activity	58%
	bank or deposit taking institution	16%
	financial planner or investment adviser	16%
	insurance broker/intermediary	11%
	investment firm or securities firm	26%
	other financial institution	5%
bank or deposit taking institution	no other activity	50%
	asset manager or mutual fund house	19%
	financial planner or investment adviser	16%
	insurance broker/intermediary	16%
	insurance company	6%
	investment firm or securities firm	25%
	other financial institution	3%
financial planner or investment adviser	insurance broker/intermediary	100%
	insurance company	25%
	other financial institution	25%
insurance company	no other activity	71%
	asset manager or mutual fund house	6%
	financial planner or investment adviser	6%
	investment firm or securities firm	18%
	pension fund	18%
investment firm or securities firm	no other activity	22%
	asset manager or mutual fund house	50%
	bank or deposit taking institution	22%
	financial planner or investment adviser	50%
	insurance broker/intermediary	33%
	other financial institution	6%

Please note: a firm had the possibility to declare several other activities, in addition to its main activity.

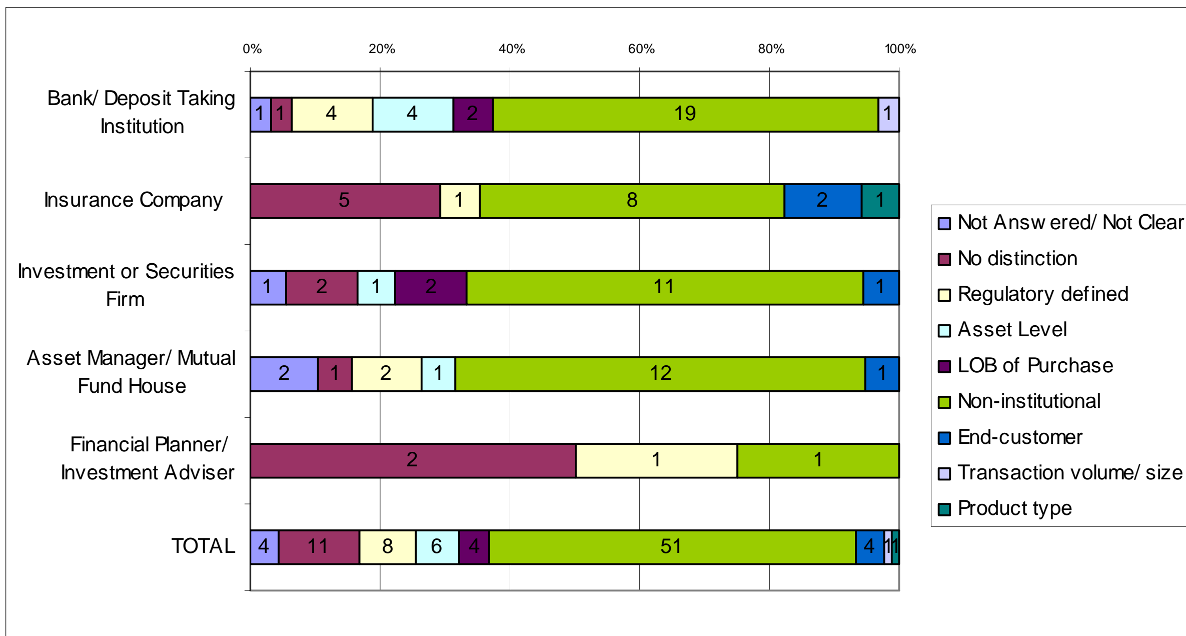
	Number	Percentage
firms having no second activity	43	48%
firms having no other activity than the 5 main activities in column 1 above	53	59%
Total	*90*	
Firms whose second activity does not include any of the four main activities, excluding financial planners/investment advisers	57	66%
Total, excluding financial planners/investment firms	*86*	*100%*

Table 18: Products and services offered by respondents

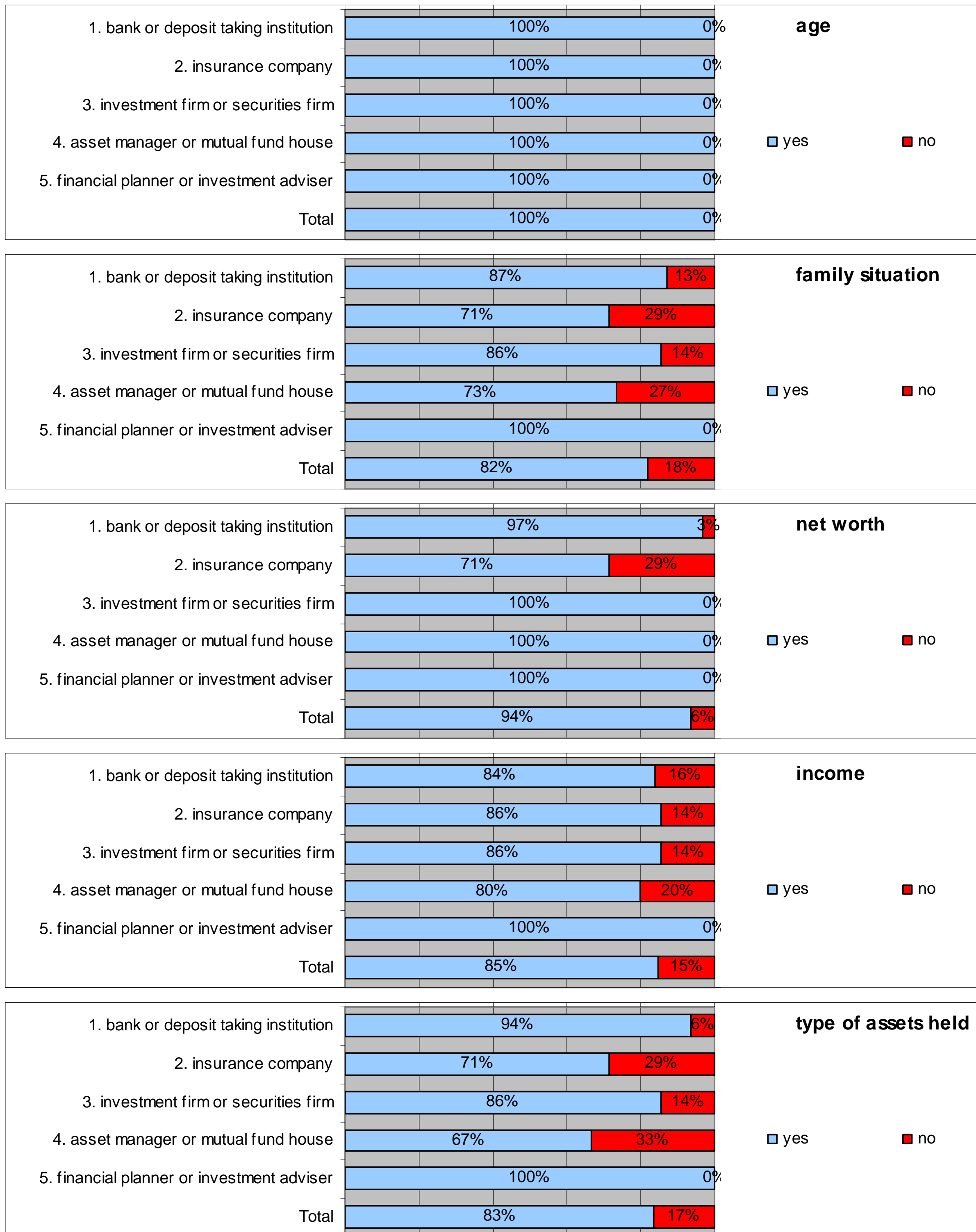
	asset manager or mutual fund house	bank or deposit taking institution	financial planner or investment adviser	insurance company	investment firm or securities firm	Grand Total
a) savings bank products	16%	**81%**	50%	12%	33%	43%
b) life insurance	16%	69%	100%	**94%**	50%	60%
c) variable insurance	5%	53%	100%	**94%**	56%	53%
d) pension fund	11%	44%	100%	**59%**	0%	33%
e) equity securities	32%	**84%**	25%	6%	**83%**	56%
f) fixed income products	32%	**81%**	50%	6%	**83%**	56%
g) derivatives	21%	66%	0%	0%	**78%**	43%
h) government/municipal securities	32%	**81%**	25%	0%	56%	48%
i) unit trusts/ units in coll. invest. undertakings	**68%**	75%	100%	18%	67%	62%
j) direct participation/ ltd partnerships	5%	16%	0%	0%	22%	11%
k) reit	16%	31%	0%	0%	28%	20%
l) hedge funds	32%	38%	0%	0%	39%	28%
m) investment advice	21%	56%	75%	18%	33%	38%
n) funds of funds	**58%**	50%	25%	12%	56%	44%
o) tax optimising investment product wrappers	21%	31%	75%	12%	22%	26%
p) structured products	26%	75%	25%	0%	33%	40%
q) invidual portfolio management (ipm)	**58%**	50%	25%	0%	33%	38%
q1) ipm discretionary	**74%**	53%	0%	0%	39%	42%
q2) ipm advisory	26%	53%	25%	0%	39%	33%
q3) ipm execution only	26%	56%	25%	6%	28%	33%
r) other	11%	25%	50%	18%	17%	20%
average	29%	56%	42%	17%	43%	

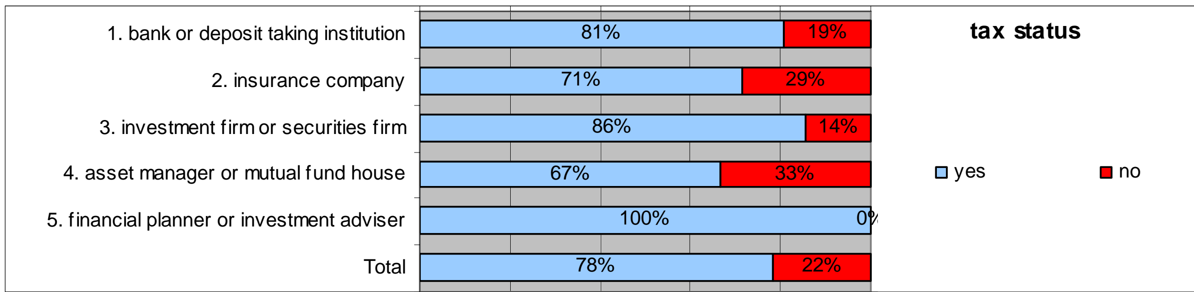
How to read this table*: the table shows which percentage of each firm category sells a given product. For instance: 84% of banks sell equity securities. Figures in bold are the 3 highest percentages of each category. Cells in grey indicate for each product which category of firm offers it most frequently (excluding financial planners).*

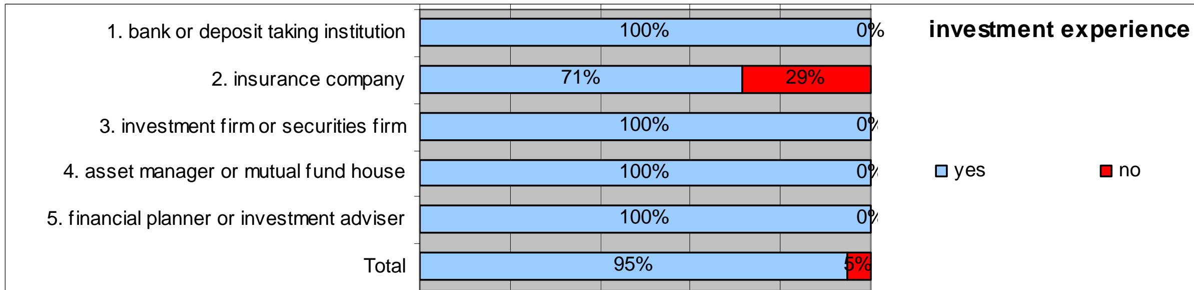
Graph 9: Retail definition components mentionned by respondents

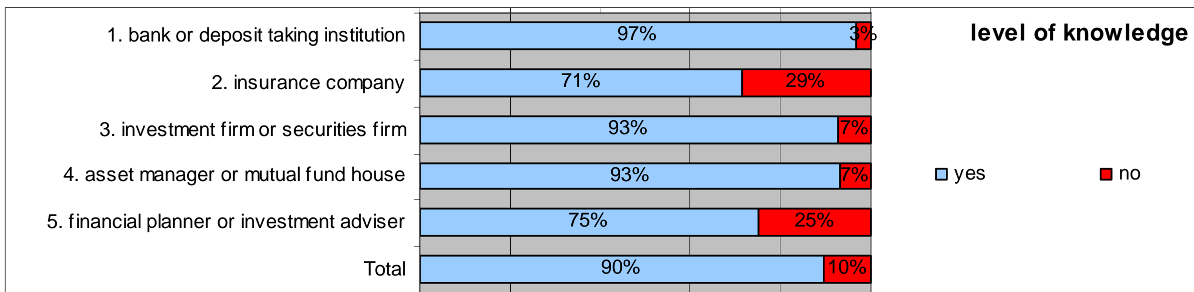


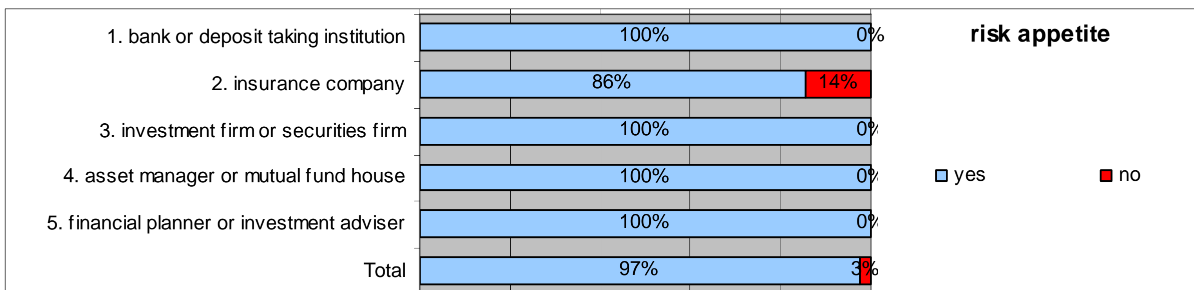
Graph 10: Information collected from customers when a recommendation is made

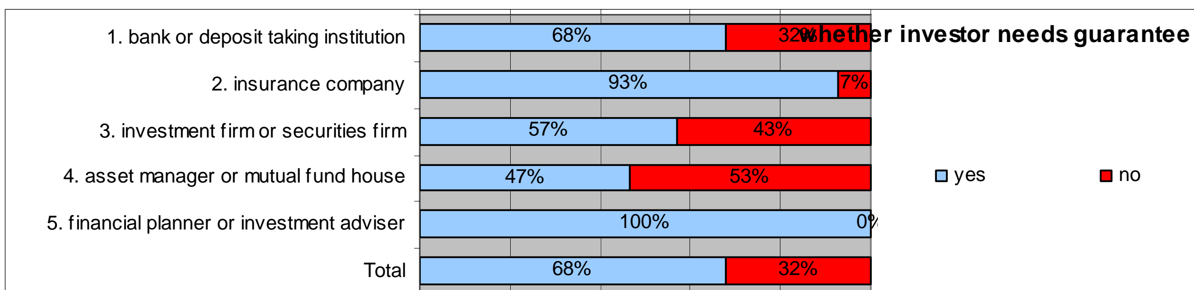


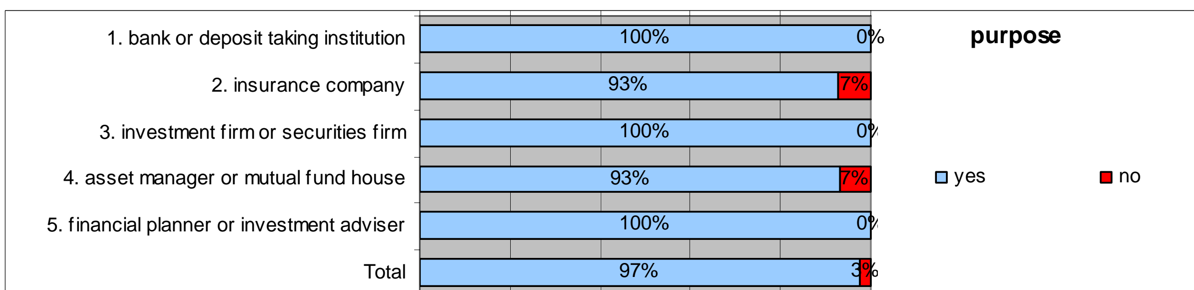

tax status
1. bank or deposit taking institution
2. insurance company
3. investment firm or securities firm
4. asset manager or mutual fund house
5. financial planner or investment adviser
Total
81% 19%
71% 29%
86% 14%
67% 33%
100% 0%
78% 22%
yes
no

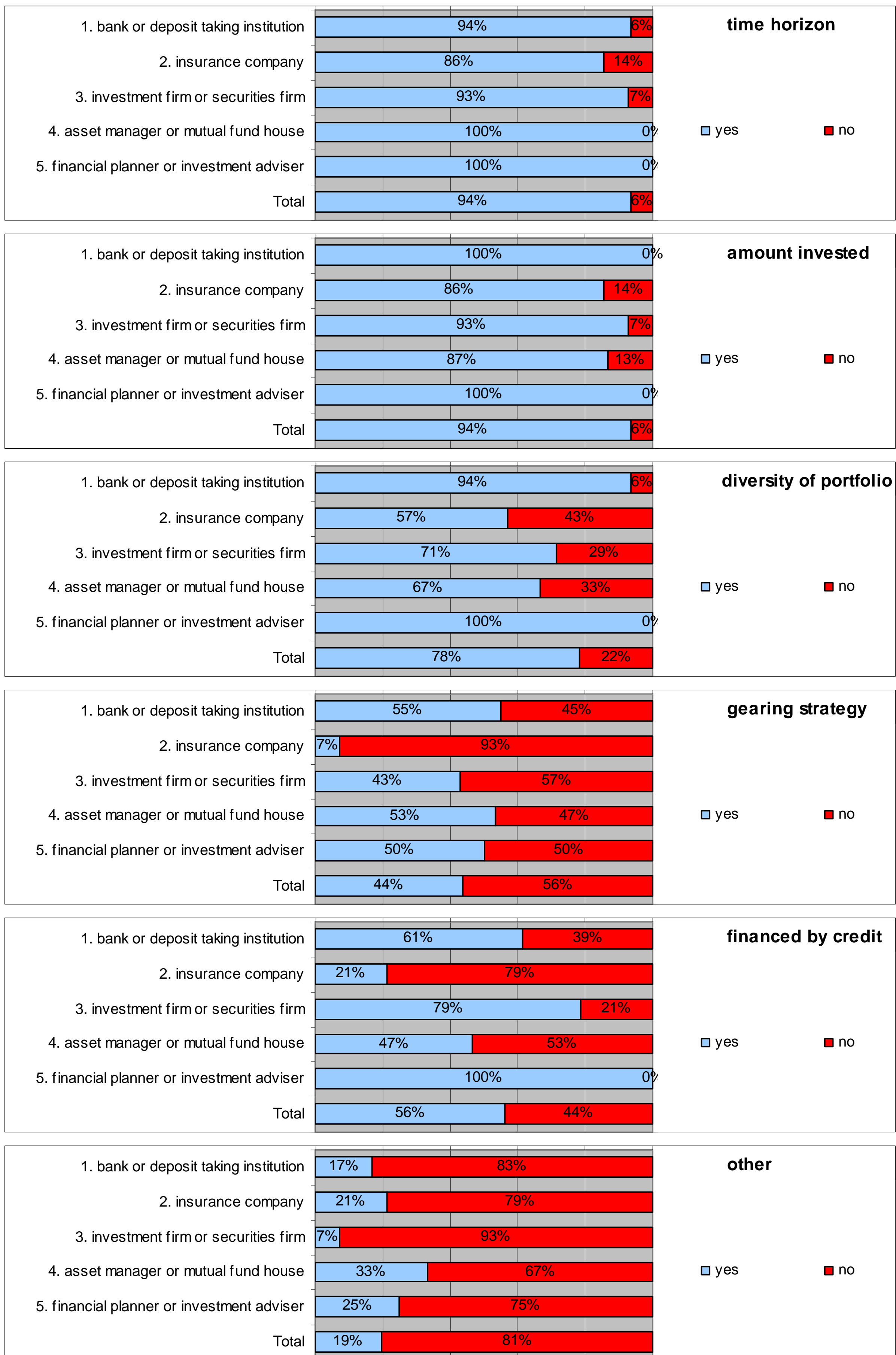

investment experience
1. bank or deposit taking institution
2. insurance company
3. investment firm or securities firm
4. asset manager or mutual fund house
5. financial planner or investment adviser
Total
100% 0%
71% 29%
100% 0%
100% 0%
100% 0%
95% 5%
yes
no


level of knowledge
1. bank or deposit taking institution
2. insurance company
3. investment firm or securities firm
4. asset manager or mutual fund house
5. financial planner or investment adviser
Total
97% 3%
71% 29%
93% 7%
93% 7%
75% 25%
90% 10%
yes
no


risk appetite
1. bank or deposit taking institution
2. insurance company
3. investment firm or securities firm
4. asset manager or mutual fund house
5. financial planner or investment adviser
Total
100% 0%
86% 14%
100% 0%
100% 0%
100% 0%
97% 3%
yes
no

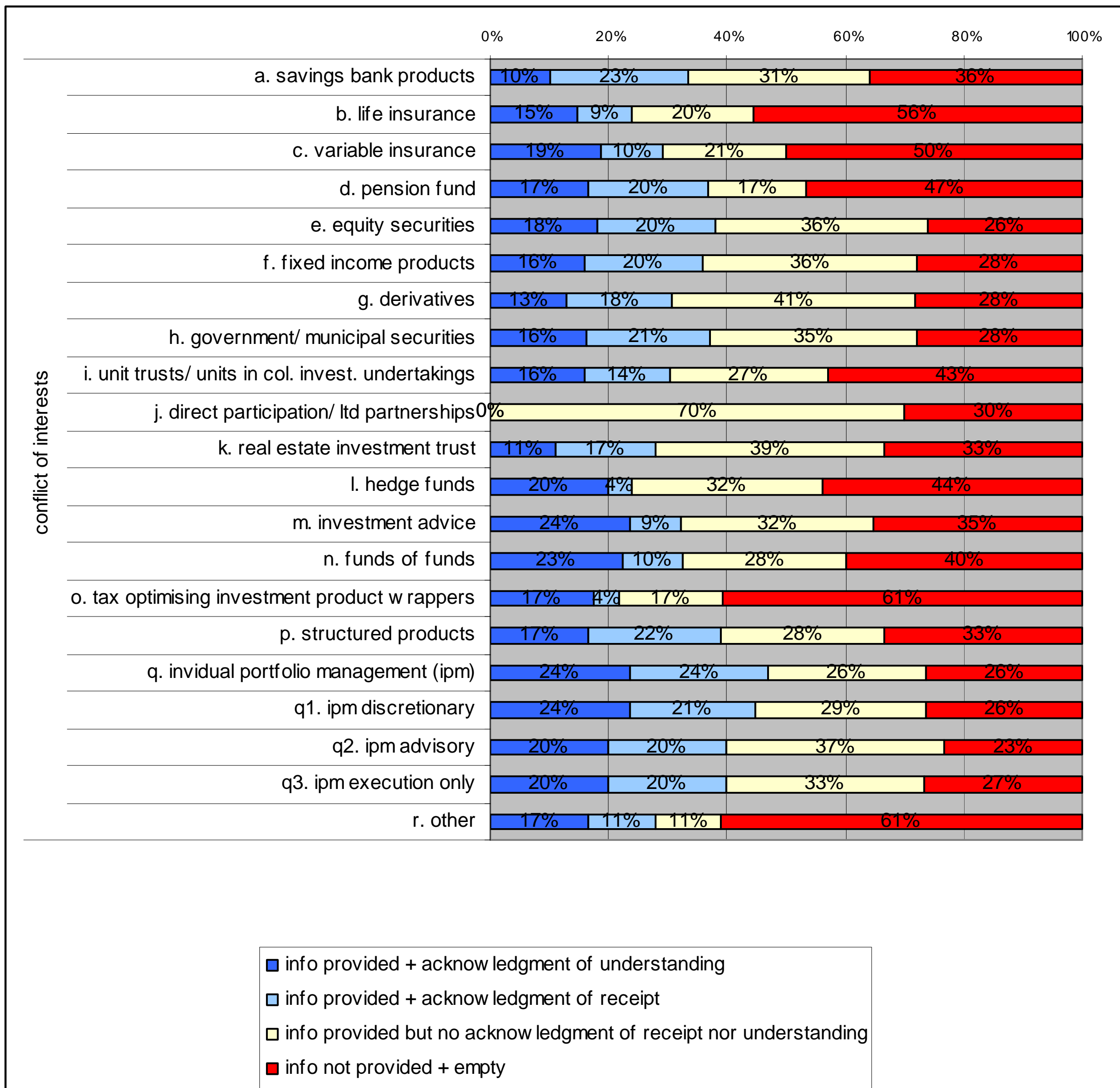

whether investor needs guarantee
1. bank or deposit taking institution
2. insurance company
3. investment firm or securities firm
4. asset manager or mutual fund house
5. financial planner or investment adviser
Total
68% 32%
93% 7%
57% 43%
47% 53%
100% 0%
68% 32%
yes
no


purpose
1. bank or deposit taking institution
2. insurance company
3. investment firm or securities firm
4. asset manager or mutual fund house
5. financial planner or investment adviser
Total
100% 0%
93% 7%
100% 0%
93% 7%
100% 0%
97% 3%
yes
no

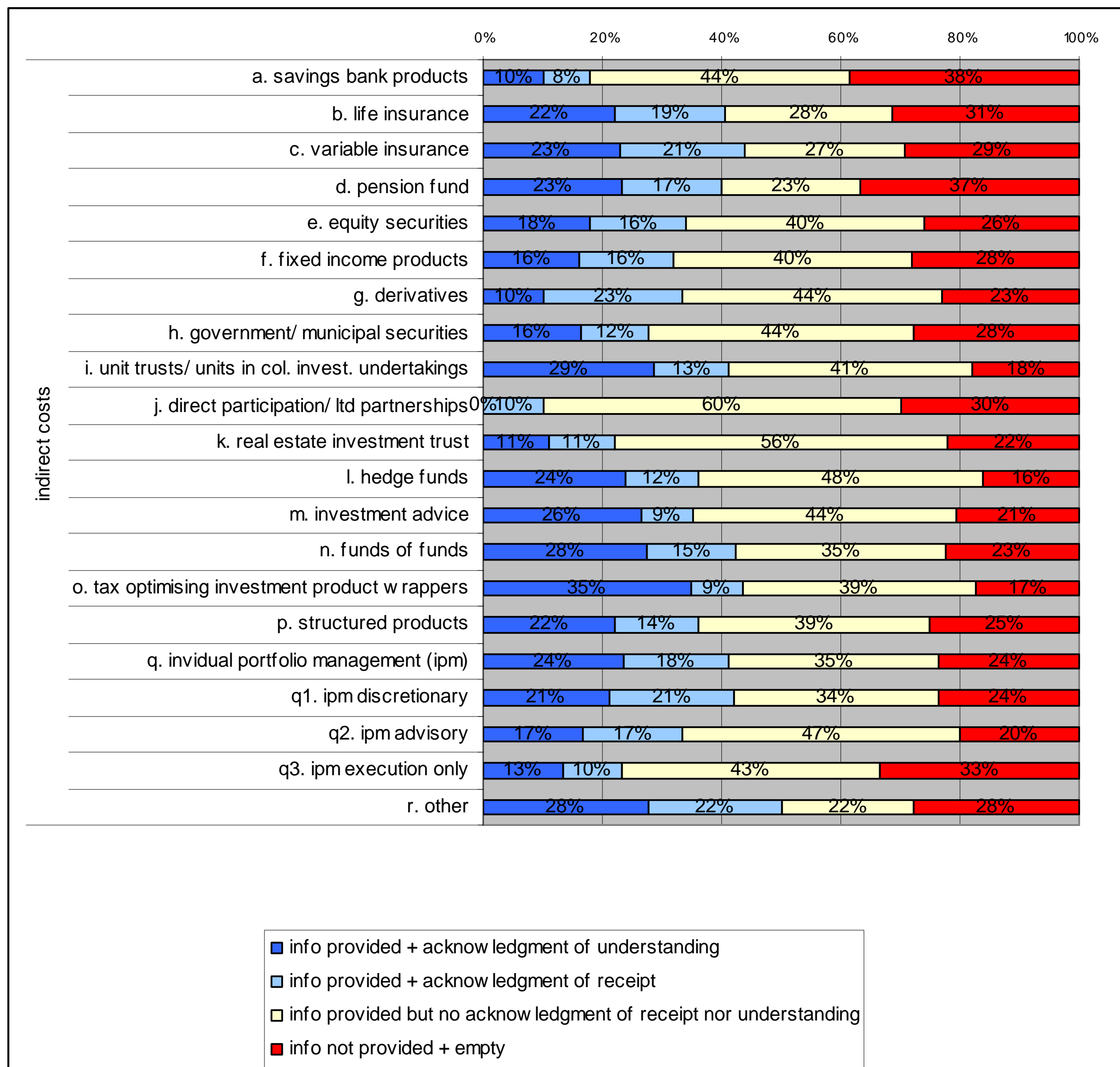


time horizon
1. bank or deposit taking institution
94%
6%
2. insurance company
86%
14%
3. investment firm or securities firm
93%
7%
4. asset manager or mutual fund house
100%
0%
5. financial planner or investment adviser
100%
0%
Total
94%
6%
yes
no
amount invested
1. bank or deposit taking institution
100%
0%
2. insurance company
86%
14%
3. investment firm or securities firm
93%
7%
4. asset manager or mutual fund house
87%
13%
5. financial planner or investment adviser
100%
0%
Total
94%
6%
yes
no
diversity of portfolio
1. bank or deposit taking institution
94%
6%
2. insurance company
57%
43%
3. investment firm or securities firm
71%
29%
4. asset manager or mutual fund house
67%
33%
5. financial planner or investment adviser
100%
0%
Total
78%
22%
yes
no
gearing strategy
1. bank or deposit taking institution
55%
45%
2. insurance company
7%
93%
3. investment firm or securities firm
43%
57%
4. asset manager or mutual fund house
53%
47%
5. financial planner or investment adviser
50%
50%
Total
44%
56%
yes
no
financed by credit
1. bank or deposit taking institution
61%
39%
2. insurance company
21%
79%
3. investment firm or securities firm
79%
21%
4. asset manager or mutual fund house
47%
53%
5. financial planner or investment adviser
100%
0%
Total
56%
44%
yes
no
other
1. bank or deposit taking institution
17%
83%
2. insurance company
21%
79%
3. investment firm or securities firm
7%
93%
4. asset manager or mutual fund house
33%
67%
5. financial planner or investment adviser
25%
75%
Total
19%
81%
yes
no

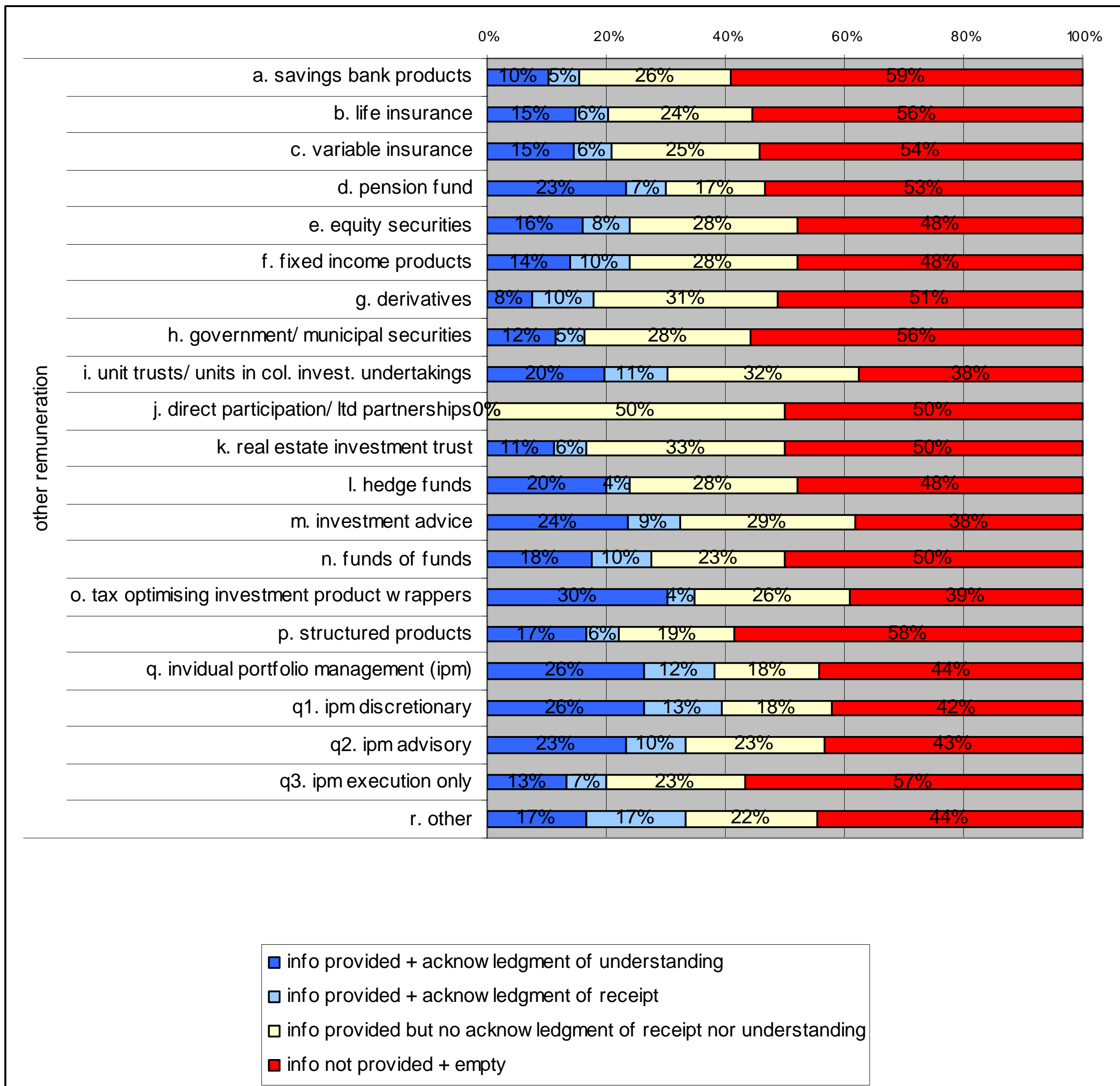
Graph 11: Disclosure of conflicts of interest to customers – comparison by products



Graph 12: Disclosure of indirect costs to customers – comparison by products

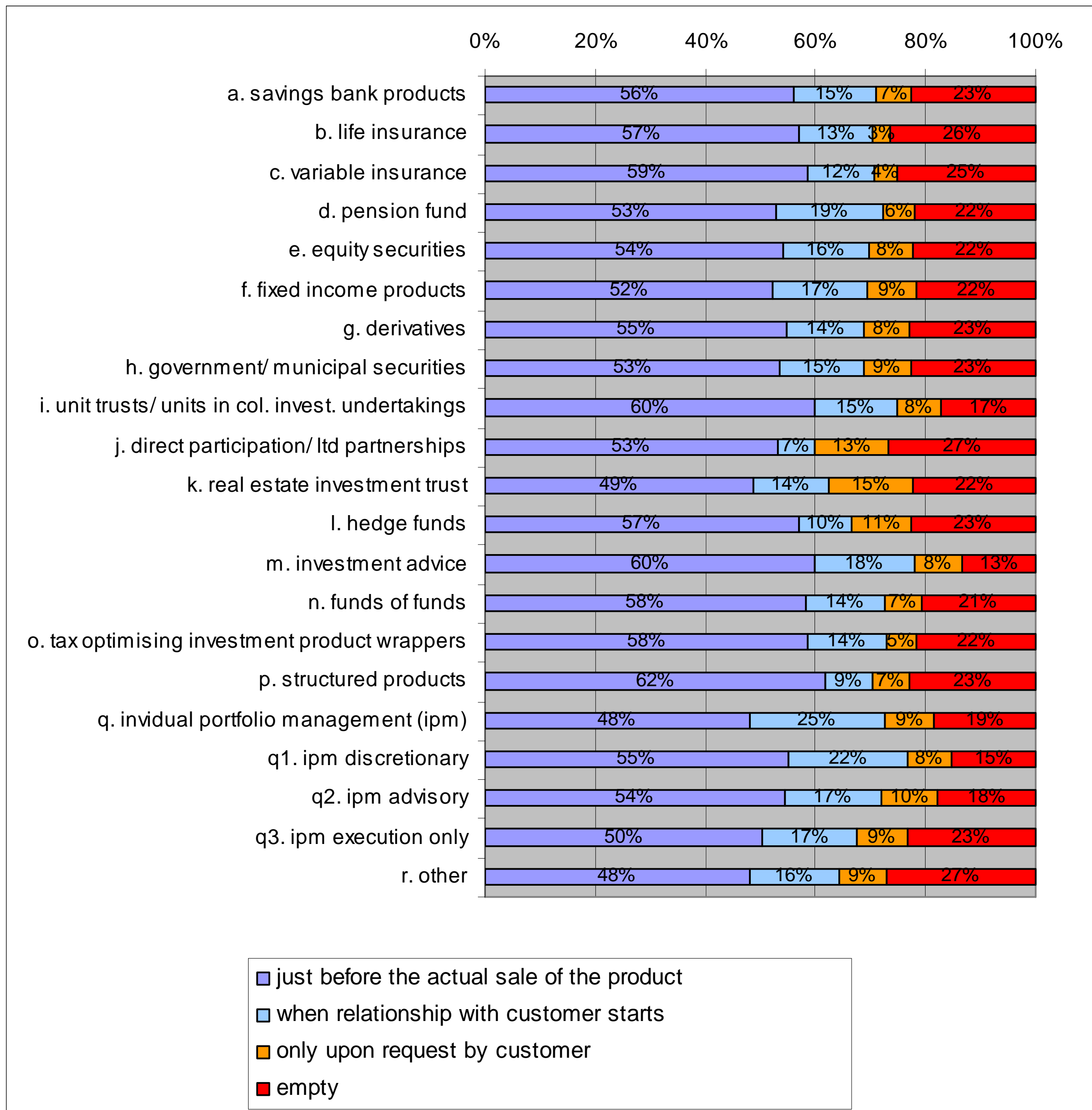


Graph 13: Disclosure of other remuneration to customers – comparison by products

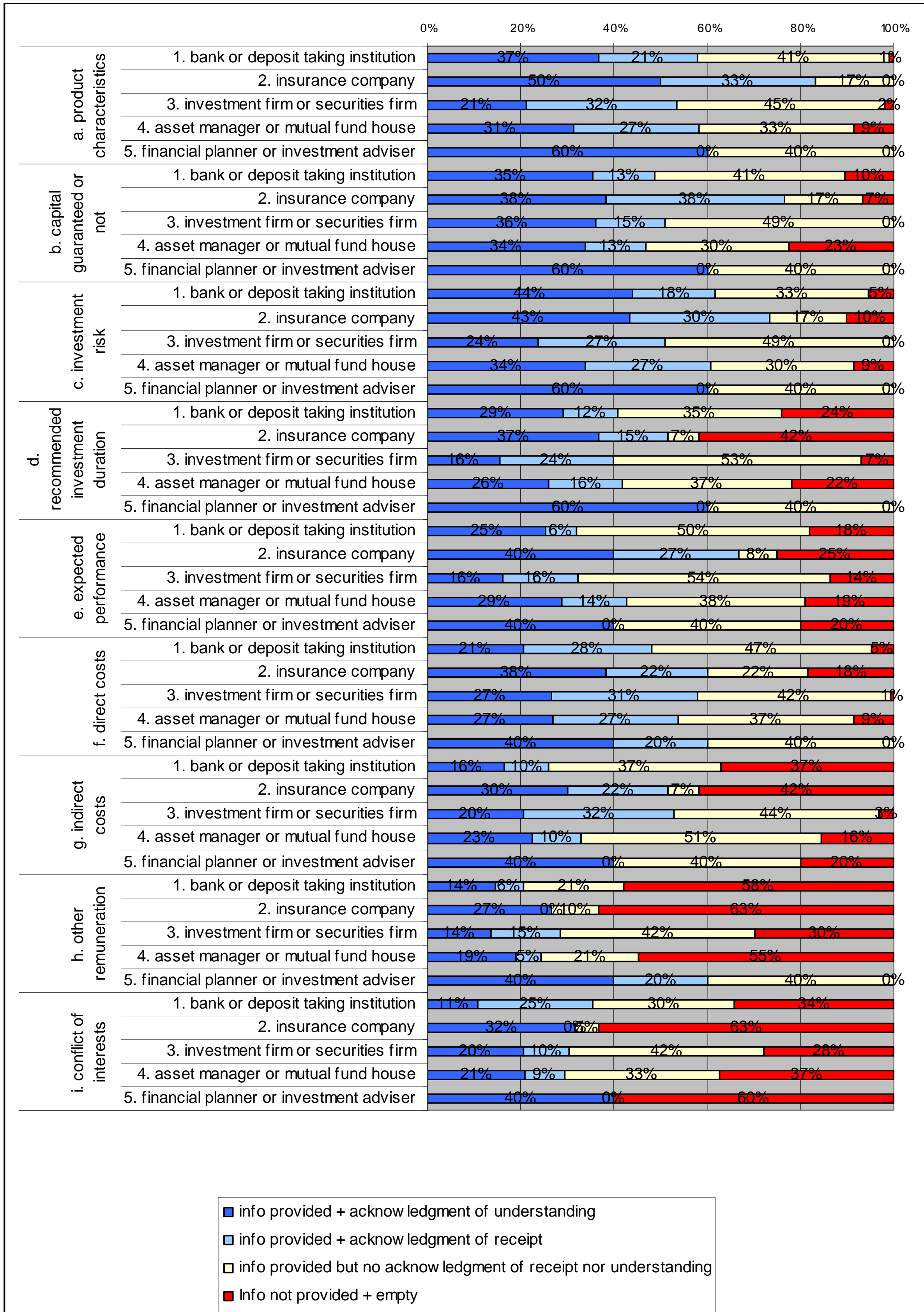


"Other remuneration" refers to the amount of structure of other remuneration, not borne by the customer, received by the firm for the sale.

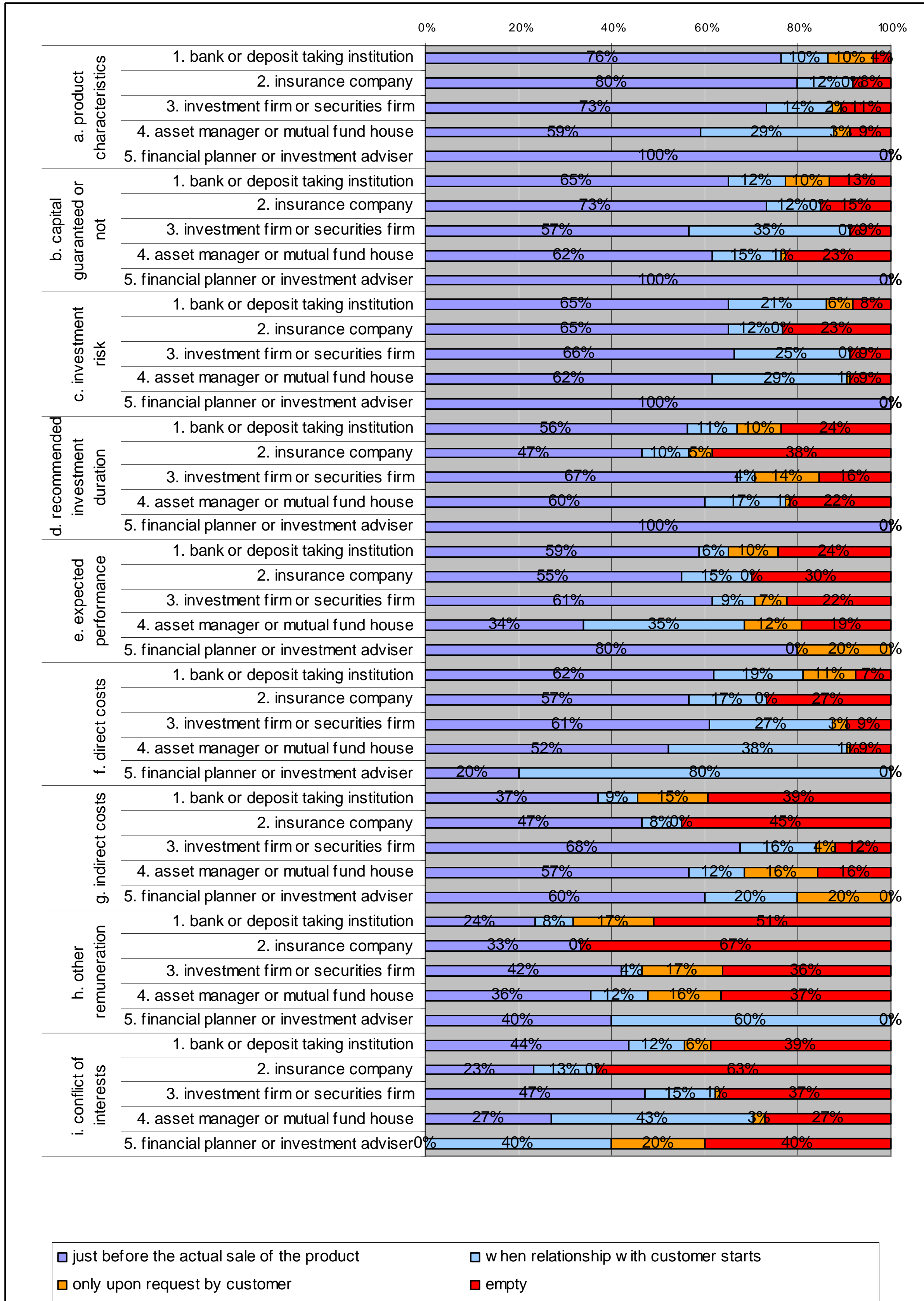
Graph 14: Timing of information provided – breakdown by product



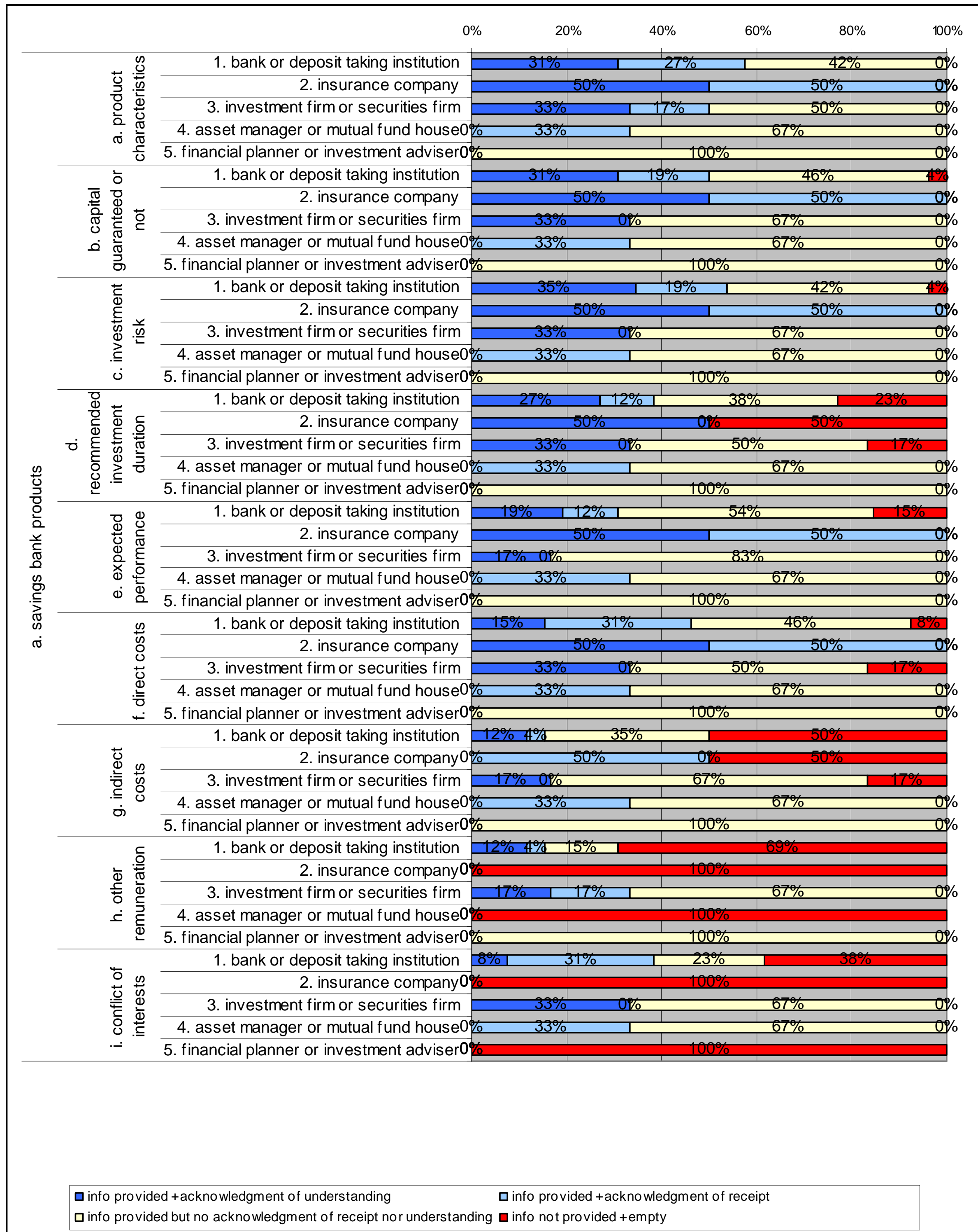
Graph 15: Information provided to customers and acknowledgements of receipt or understanding – breakdown by information category and firm type



Graph 16: Timing of information provided to customers – breakdown by information category and firm type

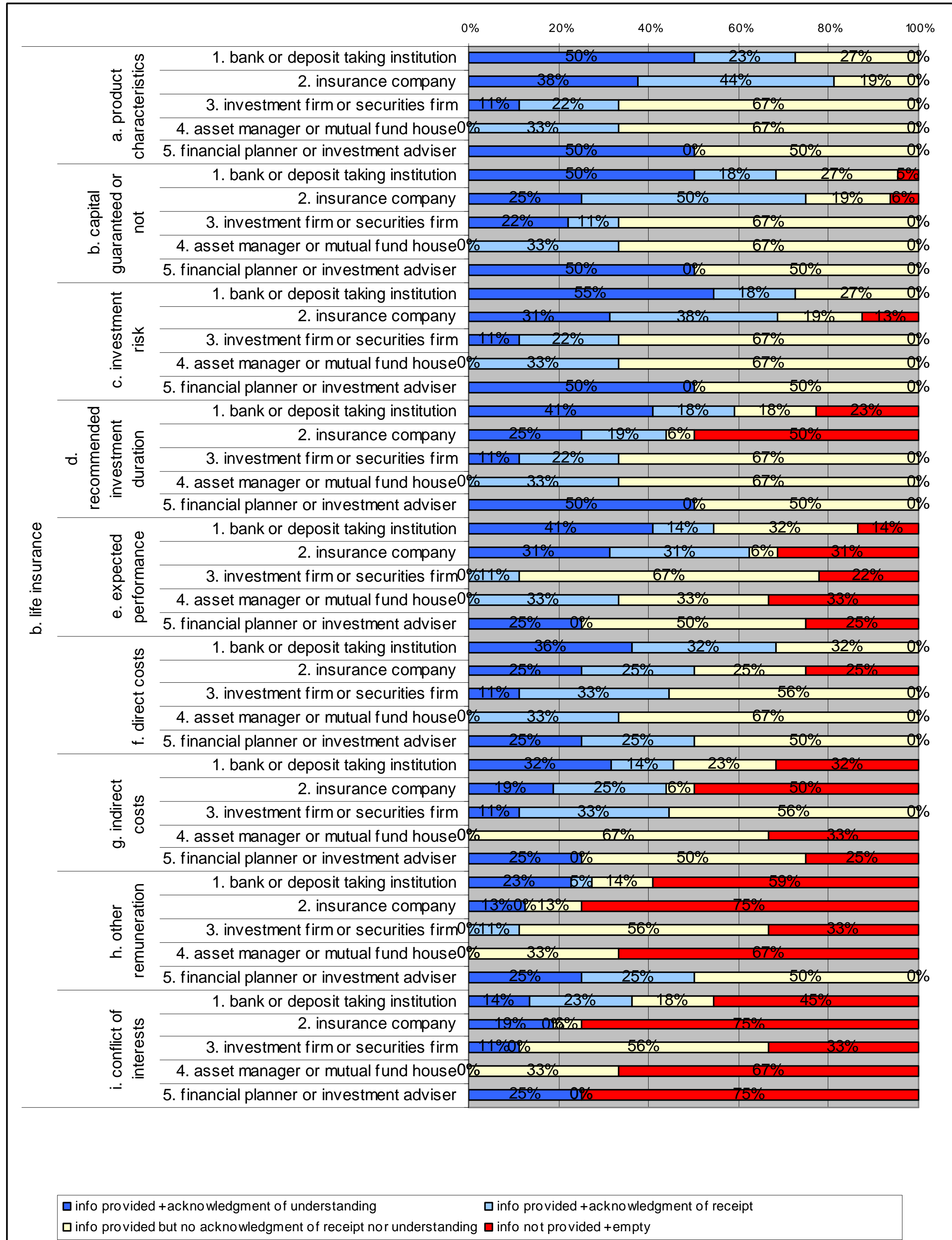


Graph 17: Information provided to customers and acknowledgements for saving bank products – breakdown by information category and firm type



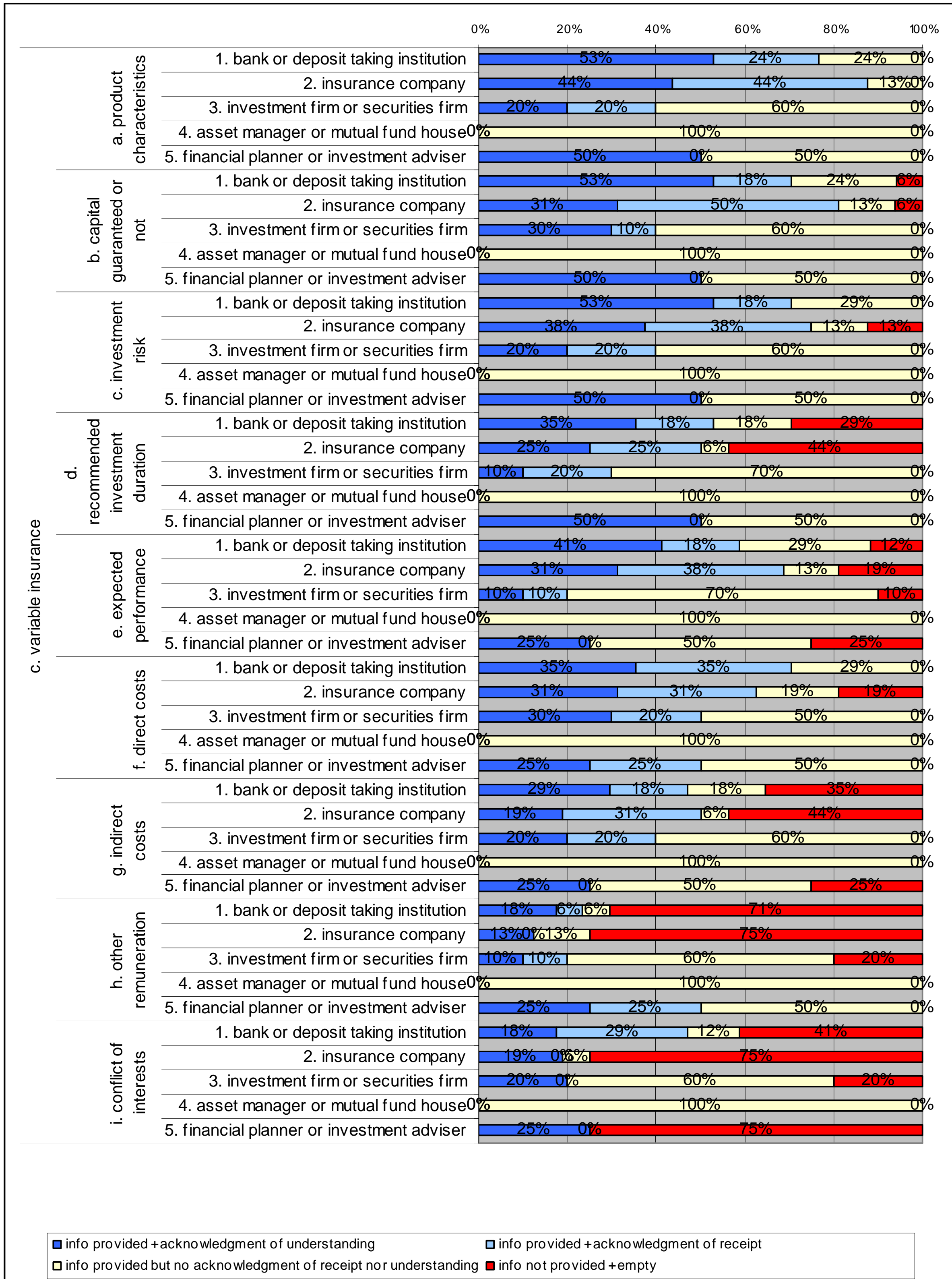
Please note: the only responses taken into account here are those provided by firms offering saving bank product. For instance, only 2 insurance companies offer such products.

Graph 18: Information provided to customers and acknowledgements for life insurance – breakdown by information category and firm type



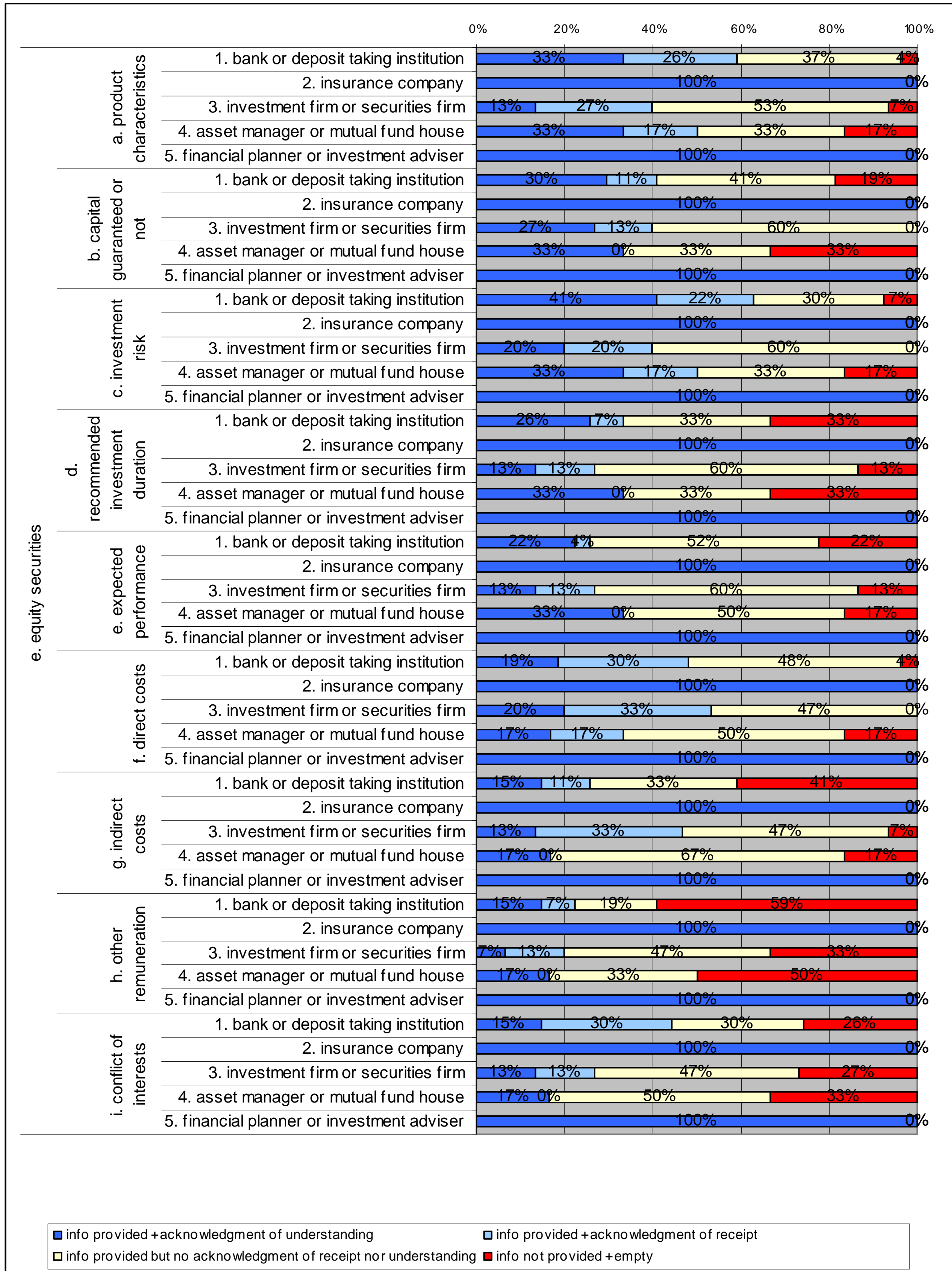
Please note: the only responses taken into account here are those provided by the 54 firms offering life insurance: 22 banks, 16 insurance companies, 9 investment firms, 3 asset managers and 4 financial planners.

Graph 19: Information provided to customers and acknowledgements for variable insurance – breakdown by information category and firm type



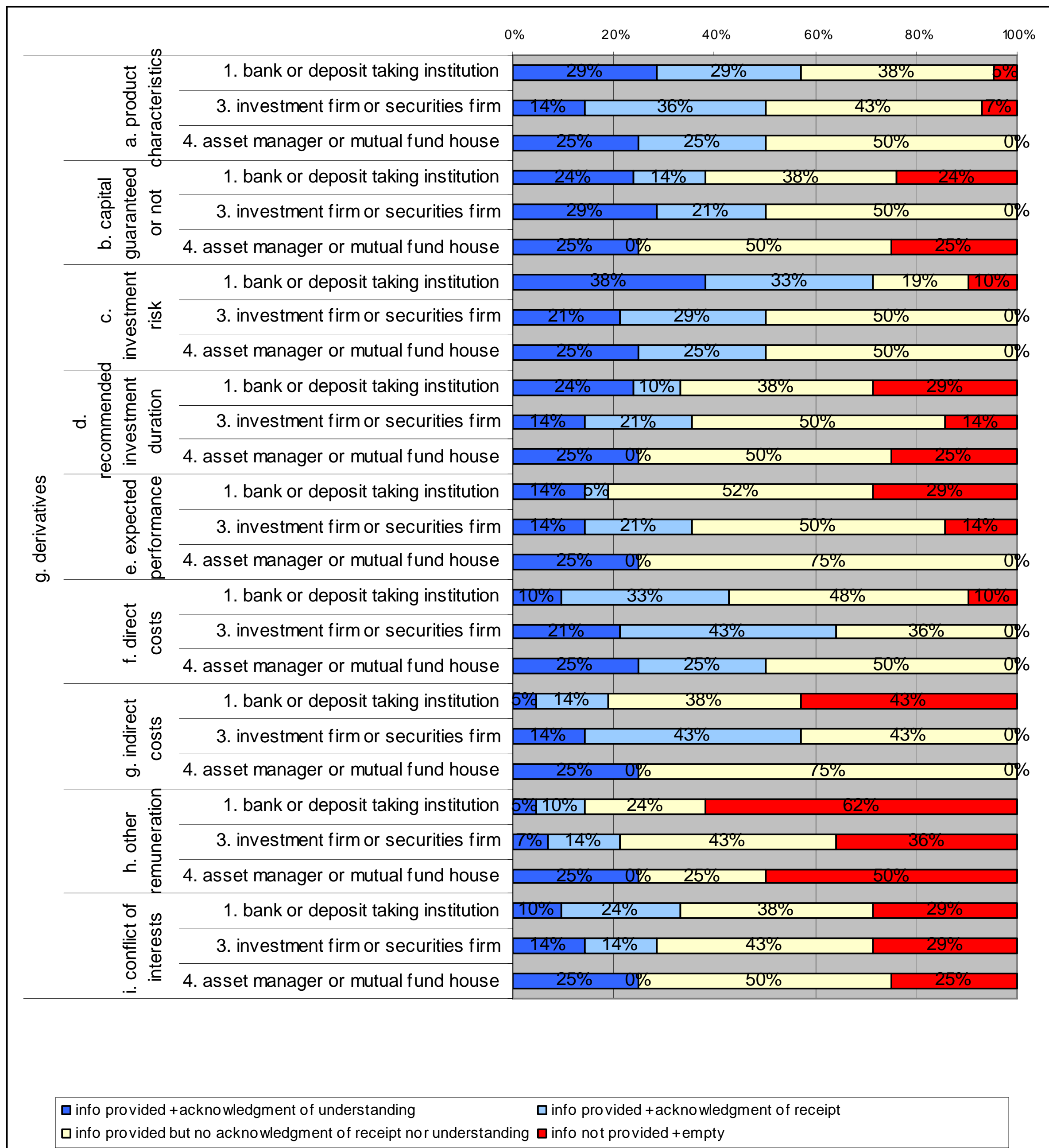
Please note: the only responses taken into account here are those provided by the 48 firms offering variable insurance: 17 banks, 16 insurance companies, 10 investment firms, 1 asset managers and 4 financial planners.

Graph 20: Information provided to customers and acknowledgements for equity securities – breakdown by information category and firm type



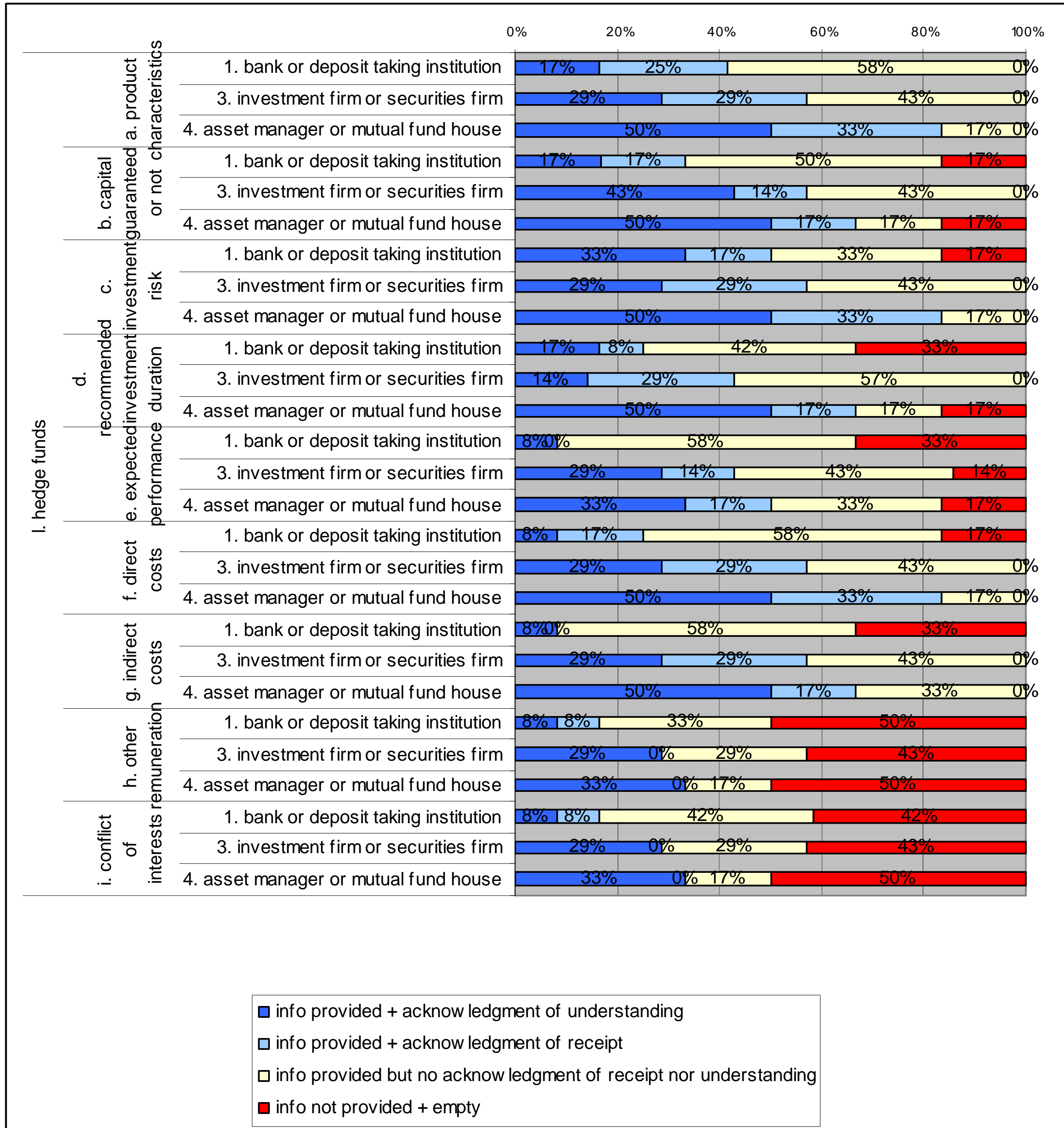
Please note: the only responses taken into account here are those provided by the 50 firms offering equity securities (27 banks, 15 investment firms, 6 asset managers; 1 insurance company and 1 investment adviser)

Graph 21: Information provided to customers and acknowledgements for derivatives – breakdown by information category and firm type



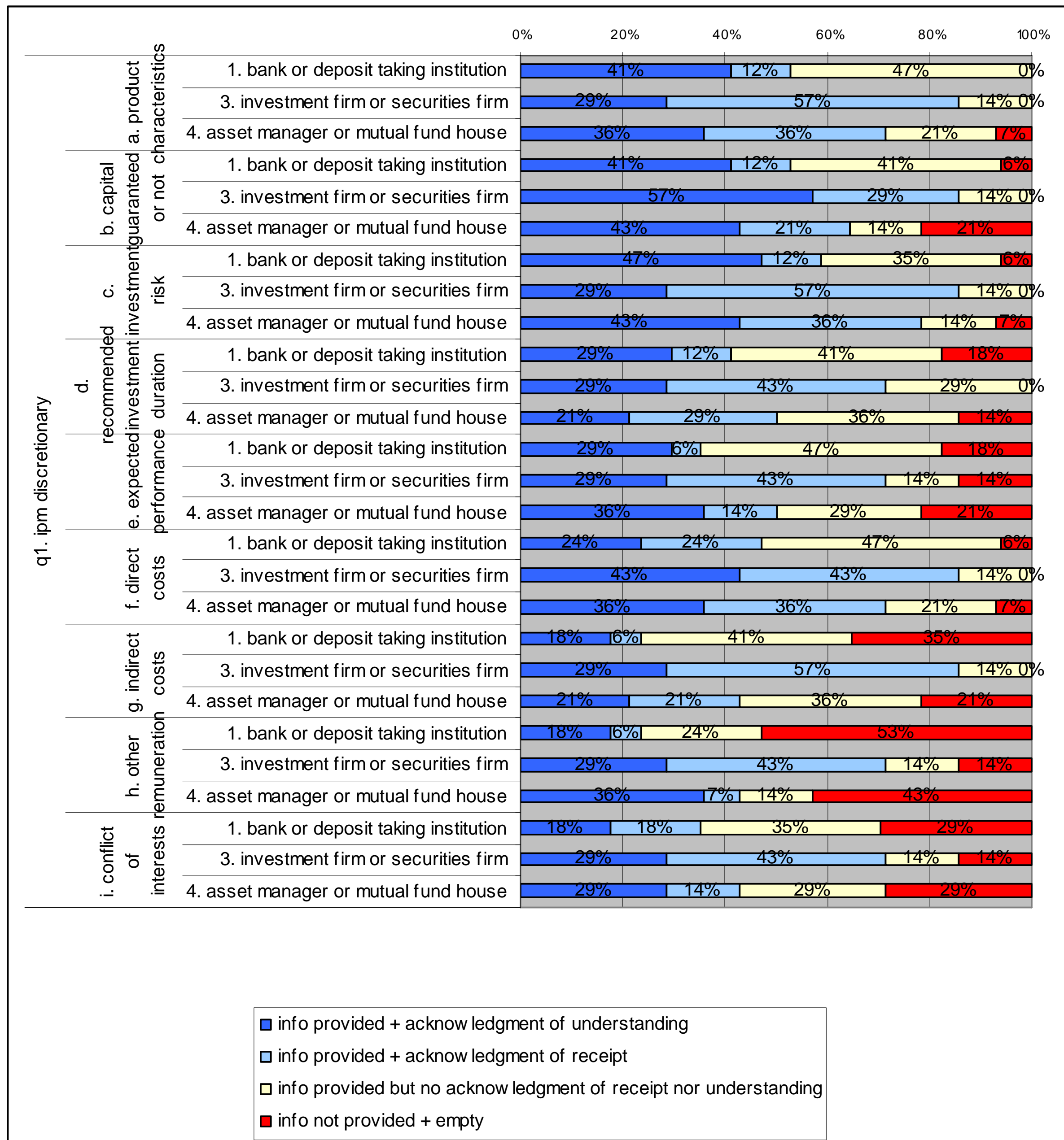
Please note: the only responses taken into account here are those provided by the 39 firms offering derivatives (21 banks, 14 investment firms, 4 asset managers)

Graph 22: Information provided to customers and acknowledgements for hedge funds – breakdown by information category and firm type



Please note: the only responses taken into account here are those provided by the 25 firms offering hedge funds (12 banks, 7 investment firms, 6 asset managers)

Graph 23: Information provided to customers and acknowledgements for discretionnary individual portfolio management – breakdown by information category and firm type



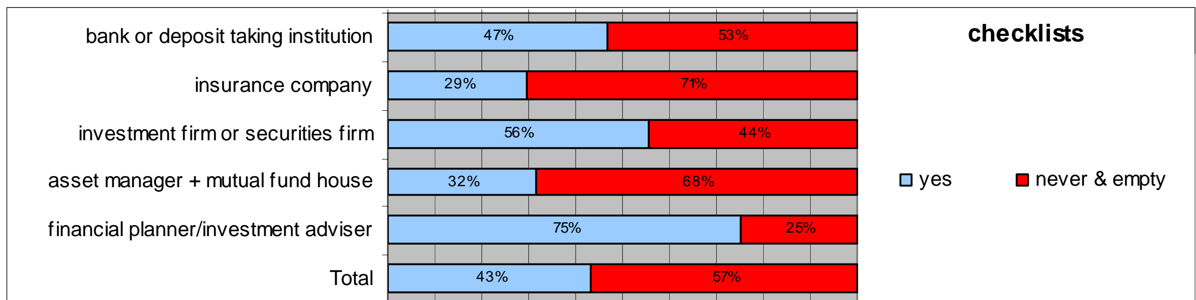
Please note: the only responses taken into account here are those provided by the 38 firms offering discretionary individual portfolio management (17 banks, 7 investment firms, 14 asset managers)

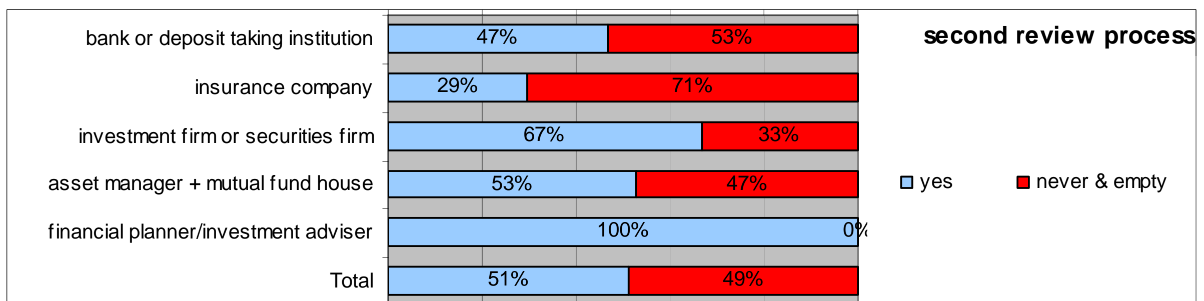
Table 19: Frequency of written disclosure to customers – comparision by information category

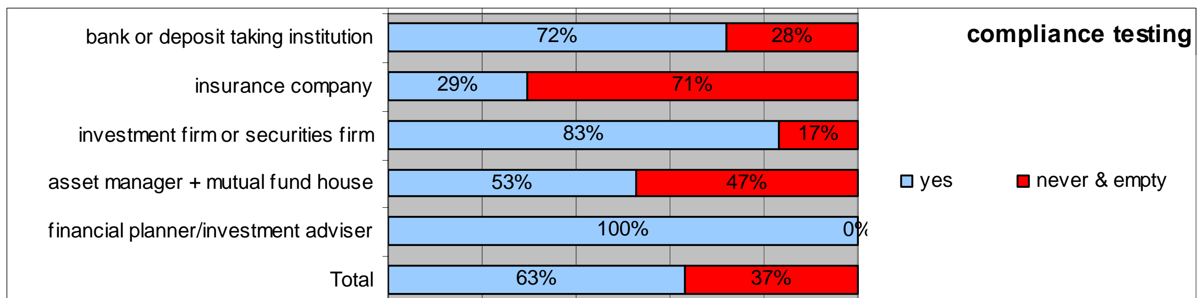
information category	banks	insurance companies	investment firms	asset manager	financial planner
a. product characteristics	100%	100%	98%	100%	100%
b. capital guaranteed or not	94%	100%	100%	100%	100%
c. investment risk	96%	100%	97%	100%	100%
d. recommended investment duration	68%	91%	91%	97%	100%
e. expected performance	86%	93%	82%	86%	100%
f. direct costs	100%	100%	100%	92%	100%
g. indirect costs	92%	91%	96%	92%	100%
h. other remuneration	90%	100%	83%	85%	100%
i. conflict of interests	78%	100%	100%	89%	100%
Total	90%	97%	95%	94%	100%

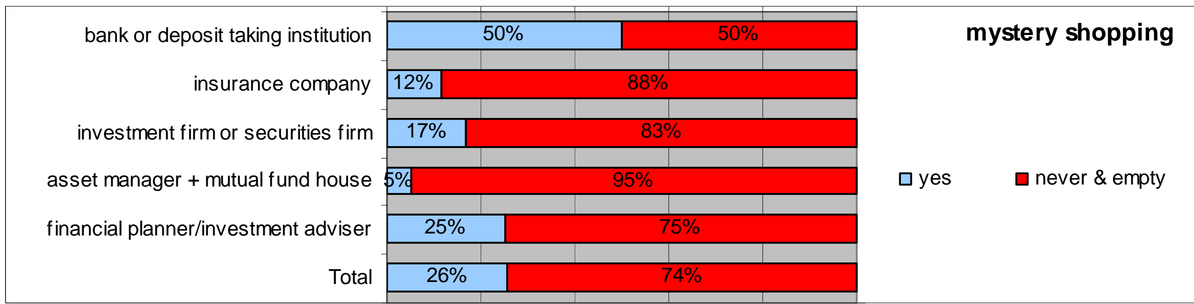
For this table, the percentages take only into account cases where a form of disclosure has been specified. Consequently, in this table, a written communication by banks in 68% of cases by banks means that oral discussions is the only form of disclosure in 32% of cases.

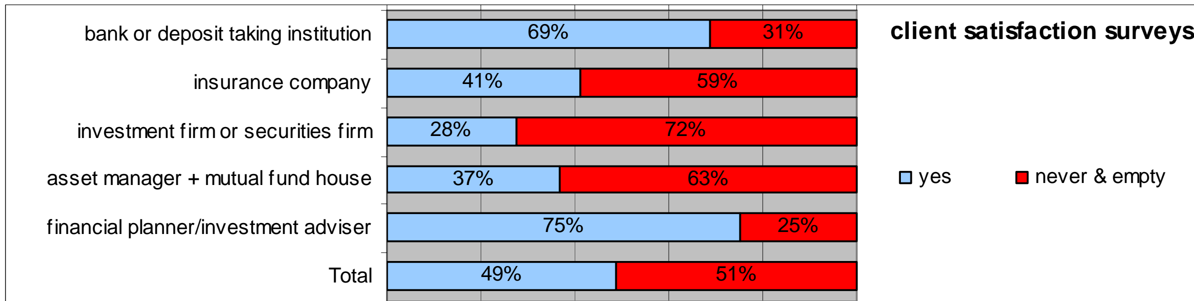
Graph 24: Procedures in place to monitor compliance with the suitability policy when a recommendation is made (frequency)

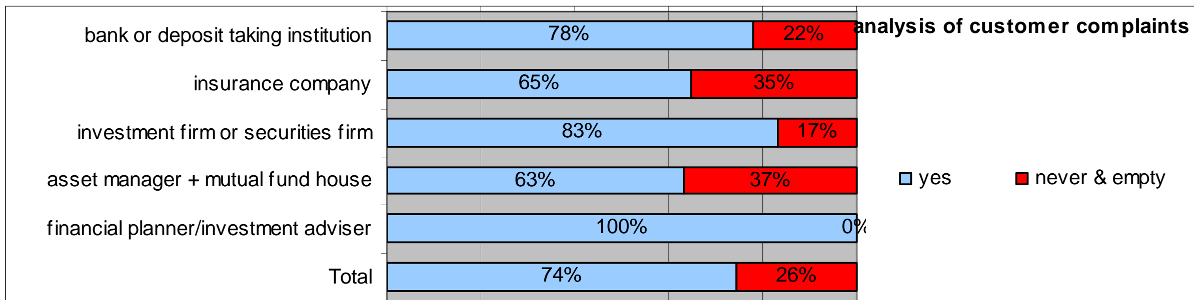


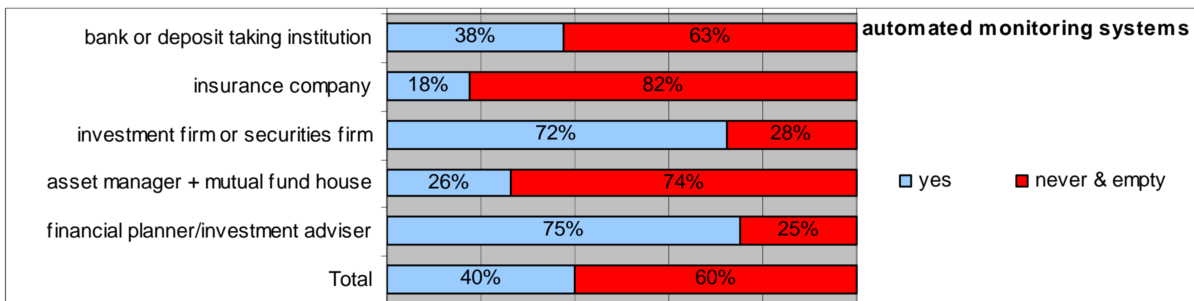





mystery shopping
bank or deposit taking institution
insurance company
investment firm or securities firm
asset manager + mutual fund house
financial planner/investment adviser
Total
50%
50%
12%
88%
17%
83%
5%
95%
25%
75%
26%
74%
yes
never & empty


client satisfaction surveys
bank or deposit taking institution
insurance company
investment firm or securities firm
asset manager + mutual fund house
financial planner/investment adviser
Total
69%
31%
41%
59%
28%
72%
37%
63%
75%
25%
49%
51%
yes
never & empty


analysis of customer complaints
bank or deposit taking institution
insurance company
investment firm or securities firm
asset manager + mutual fund house
financial planner/investment adviser
Total
78%
22%
65%
35%
83%
17%
63%
37%
100%
0%
74%
26%
yes
never & empty


automated monitoring systems
bank or deposit taking institution
insurance company
investment firm or securities firm
asset manager + mutual fund house
financial planner/investment adviser
Total
38%
63%
18%
82%
72%
28%
26%
74%
75%
25%
40%
60%
yes
never & empty

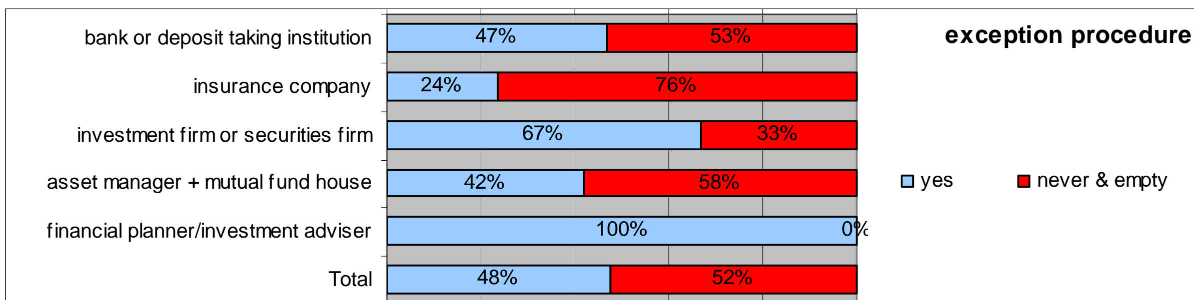

exception procedure
bank or deposit taking institution
insurance company
investment firm or securities firm
asset manager + mutual fund house
financial planner/investment adviser
Total
47%
53%
24%
76%
67%
33%
42%
58%
100%
0%
48%
52%
yes
never & empty

Table 20 Policy applied by firms offering higher risk products compared to other firms

		use forms to collect information	Take into account suitability regulatory requirements when developing marketing/advertising for new products	specific compliance group or officer in charge of suitability	sales agents/ advisers receive compliance training	take into account compliance in their incentive policy	Record keeping of suitability determination	Record keeping of information obtained from customer
bank or deposit taking institution	HR	71%	93%	100%	100%	50%	86%	93%
	other	50%	83%	89%	89%	67%	83%	94%
investment firm or securities firm	HR	92%	92%	100%	100%	54%	85%	100%
	other	100%	80%	100%	80%	60%	80%	100%
asset manager + mutual fund house	HR	100%	100%	100%	100%	67%	83%	100%
	other	92%	92%	100%	85%	62%	92%	100%

HR: Firms offering higher risk products (hedge funds and/or investment in direct participation programs or limited partnership)

Annex B

Case studies

Case Study 1:
SUPERANNUATION SWITCHING ADVICE GIVEN BY FINANCIAL PLANNERS In July 2006, the Australian Securities & Investments Commission (ASIC) accepted an Enforceable Undertaking (EU) from a financial planning company (COMPANY A). The EU related primarily to the provision of superannuation (Private Pension Funds) switching advice and set out how COMPANY A was to modify key aspects of how it provides financial advice to its clients. The EU was a result of an extensive monitoring of COMPANY A's operations by ASIC between October 2005 and April 2006. During this period, ASIC reviewed COMPANY A's policies and procedures and 300 switching advice files selected from 30 COMPANY A planners chosen at random, as well as holding discussions with COMPANY A's management and planners. ASIC's analysis of the files and subsequent investigations found that on many occasions, COMPANY A: • planners' files did not disclose a reasonable basis for advice (the planner's reasons as to why their client should move funds) when recommending a change in superannuation fund. Of the superannuation switching advice files selected, ASIC found that 45% failed to adequately disclose a reasonable basis for the advice; • failed to make proper disclosures about the costs of acquiring the recommended product and the significant consequences of replacing the existing product; • made statements on its website and in its disclosure documents that suggested COMPANY A planners could consider a broader range of products than permitted, which could have misled consumers; and • may not have had adequate arrangements in place to manage conflicts of interest. The EU offered by COMPANY A sets out how it was to rectify these issues and how it would provide suitable redress for clients who received advice which did not have a reasonable basis. In order to meet its obligation to provide client redress, COMPANY A has contacted 35,000 clients (out of COMPANY A's 720,000 retail superannuation clients) to offer a review of their advice. Initially the number of clients COMPANY A had to contact was estimated to be 7,000, but this number increased (with the inclusion of existing COMPANY A's retail superannuation clients as well as new retail superannuation clients) as a result of COMPANY A's own verification process as well as discussions with ASIC and an external expert. In circumstances where COMPANY A had no reasonable basis of advice (or that basis was not adequately documented), COMPANY A will re-credit entry fees, compensate for exit fees and transfer balances back to the original funds and ensure clients insurance arrangements are not affected. In addition to reviewing client files, COMPANY A was required to address a number of matters as part of the EU in the following way: • introduction of a new management structure with much sharper focus on compliance and improving processes and procedures; • the development of updated disclosure documents; • testing of updated disclosure documents with consumers to help COMPANY A understand how it can make them more meaningful; • amendment of COMPANY A's Professional Standards Manual (which sets out the

processes and practices that planners must follow) to include clearer disclosure guidance;

- mandated training for all COMPANY A planners focused on helping them understand and improve their processes for having a reasonable basis for their advice and properly documenting it;
- introduction of mandatory reviews of all cases where a COMPANY A planner recommends that its clients switch superannuation funds;
- clearer disclosure of the range of products offered to clients, with a list of the approved products and services list on the website and available to any clients on request;
- clarified the content in the disclosure documents to make it clearer to clients the potential conflicts of interest that exist in COMPANY A's business model and how these conflicts may influence advice clients are provided;
- appointment of an external expert to review its processes, training and documentation to ensure they are robust and effective; and
- restructuring key compliance, training and support functions.

The cost to Company A of client redress was large; it was estimated that the EU impacted COMPANY A's net cash flows to the tune of A$21 million in the September 2006 quarter. However, the biggest impact on COMPANY A has been reputational damage.

Case Study 2:

INADEQUATE INFORMATION PROVIDED TO CUSTOMERS OF UNIT LINKED INSURANCE PRODUCTS

A unit linked insurance policy is one in which the policyholder is provided with life insurance cover and the premium paid is invested in either debt or equity products or a combination of the two. These life policies enable the policyholder to secure protection for their family in event of their death, and at the same time provide them with an opportunity to earn a return on their premiums. In the event of the policyholder's death, their nominees would normally receive an amount that is the higher of the sum assured (insurance cover) or the value of the units (investments). However some schemes enable the policyholder to receive the sum assured plus the value of the investments.

The demand for this type of insurance policy has risen steadily in recent years. In Europe, unit linked insurance products grew an average annual rate of 24% between 1996 and 2000 to represent 45% of total life insurance premiums*. This trend was slowed by the stock market downturn in 2001, but since then the sale of these types of products has again grown at a fast rate and now represents an important share of the life insurance sector. This was and is especially true in countries such as the UK, Sweden, Belgium, the Netherlands, France and Italy. The demand for such policies is a result of several reasons including:

- the traditional special tax treatment of life insurances;
- pension reform and product innovation;
- high yields in the stock market in the late nineties;
- the active market approach by intermediaries, largely a result of their remuneration structure; and
- low interest rates and profitability of conventional insurance policies.

The downturn in the stock market in 2001 resulted in unexpected losses for many policyholders of unit linked insurance policies who had not understood that such products involve a greater transfer of risks and responsibility to policyholders (particularly in the area of asset allocation). The need for enhanced disclosure regarding the surrender value and fees attached to such policies also became apparent.

The conduct of business supervisor in the Netherlands, the Authority for the Financial Markets (AFM) issued a report in 2006 on the unit linked insurance market. The conclusions were:

- unit-linked insurance policies are complex products and information supplied to potential policyholders is often incomplete, inadequate and inaccurate. Policyholders therefore find it difficult to assess the risks and fees associated with such products;
- unit-linked insurance policies are expensive. The AFM calculated that on average 30 to 40% of a monthly deposit of EUR 100 goes into costs, fees and premiums. The fact that the cost allocation is highest in the early years not only renders such products unprofitable for policyholders to pull out early, but also affects their total return;
- intermediaries are largely remunerated by commissions and as a result do not always act in the interest of the policyholder when considering asset management; and
- serious deficiencies in the management of unit linked insurance policies lead to sub-optimal services and barely controllable operational processes.

The release of this report aroused a lot of negative media attention (particularly in respect of the high cost of such products) in the Netherlands and resulted in a significant drop in demand for unit liked insurance policies. The negative media attention was augmented by the release of results of a study undertaken by the Vereniging Eigen Huis (the Dutch Association of Home Owners). The Vereniging Eigen Huis studied the key features of 20 unit-linked insurances offered in combination with mortgages and calculated that, on average, returns on such products were poor and possibly as low as 0.8%.

In early 2007, a committee chaired by former insurance ombudsman Mr De Ruiter submitted a proposal towards enhancement of the information supplied on new policies prior to and at the time of conclusion of a unit linked insurance contract, as well as during the term of that contract. The committee also proposed to charge the initial costs of unit-linked insurances evenly distributed over time. The committee did not comment on existing cases.

As a result of this proposal, the insurance sector has committed itself to informing policyholders on costs and capital accumulated before the second half of 2008. In connection with the recommendation for unit-linked insurance contained in the De Ruiter Committee report, the Association of Insurers has advised its members as follows:

- to analyse products they provided in the past for any shortcomings;
- to inform customers about relevant aspects of their policies when issuing value statements for 2007;
- to send the Financial Services Complaints Board (KiFiD) a list of all the unit linked insurance schemes provided in the past; and
- in principle to approve a categorical approach as proposed by KiFiD.

The AFM has understood from insurers that they will actively follow these recommendations. The AFM will monitor the quality and consistency of this process as part of its supervisory duties. To this end, the AFM has asked the larger insurers to inform them about their action plans and to give them access to detailed information on these policies. In addition, the AFM has also asked the larger brokers to perform a thorough analysis of the pros and cons of unit linked products in view of their role in informing potential buyers of unit linked insurance.

***Information ascertained from the Organisation for Economic Co-Operation and Development (OECD) report entitled "Awareness and Education on Risk and Insurance Revised Analytical and Comparative Report" found at http://www.oecd.org/document/60/0,3343,en_2649_201185_38855292_1_1_1_1,00.html**

Case Study 3:

PENSION SCHEME MIS-SELLING IN THE UNITED KINGDOM IN THE 1990s

Between 1988 and 1994 in the United Kingdom, people who would have been financially better off at retirement in their employers pension scheme were advised to leave or not join their employers pension scheme, or transferred pension benefits from a previous employers scheme and took out a personal pension plan instead.

As a result of an industry-wide review sponsored by the regulators (the Securities & Investments Board and the Personal Investment Authority – the forerunners of the FSA), over 1.2 million persons asked for their cases to be reviewed by the product providers or financial advisors who had advised them to change their pension arrangements. Close to 1.1 million requests were directed at product providers (insurers, bankassurers or others), 100 000 to networks and large independent financial advisers (IFAs), and some 60 000 to small IFAs.

By June 2002, the FSA had taken disciplinary action against 346 firms, resulting in fines totaling over GBP 9.6 million. In addition, the review costs were estimated at GBP 11.5 billion in redress and 2 billion in administration costs. 90% of redress had been paid by 30 June 2002. If the firm which gave the advice no longer existed or had left the regulatory system, the FSA's own Pensions Unit carried out the loss assessment in respect of the relevant customers of that firm. If the FSA found that a loss had occurred, the case was passed to the Financial Services Compensation Scheme (FSCS).

The reputational consequences lasted long after the event. Close to 20% of consumers distrusted their independent financial advisors in February 2002, and the figure was still around 15% in November 2005 (Source: Henley Centre Headlight Vision, Planning for Consumer Change 1995 –

2005, quoted in FSA Financial Risk Outlook 2007). For banks, the percentage of customer distrust was close to 10% in October 2000.

Case Study 4:

MIS-SELLING OF SHARE LEASE AGREEMENTS IN THE NETHERLANDS

A share lease agreement is an investment instrument, whereby investors borrow money to buy shares and repay the debt with proceeds from the sale of those shares.

Between the years 1999 to 2001, when the market was booming, many share lease constructions were on offer under appealing names such as *Vermogensversneller* (Capital Accelerator), *Korting kado* (Free Discount), *Winstverdriedubbelaar* (Gains Times Three), *Sprintplan* (Sprint Plan). At the peak of the market, around 700,000 share leasing agreements, valued at EUR 6.5 billion, were outstanding mostly in the Netherlands and to a lesser extent in Belgium.

After the downturn in the stock market in 2002, a large number of investors were left with a residual debt as their investments plummeted. This situation led to claims for damages, complaints to dispute resolution bodies and civil proceedings.

The Netherlands Authority for the Financial Markets (AFM) noted that several providers of share leasing constructions were infringing statutory rules on, among other things, the information supplied to investors, advertisements, cold calling and the collection of customer information. They also held out the prospect of unduly high return. Investors were not clearly told that the investments were made with borrowed funds and providers failed to highlight changes in tax legislation relevant to share leasing constructions. Where compliance with the "general duty of care" was concerned, the AFM drew the overall conclusion that most of the providers of share lease constructors it investigated had not or insufficiently complied with one or several aspects of their duty of care.

In the Netherlands most share leasing agreements were sold by Bank A. Between 1992 and 2003, Bank A signed share lease agreements with nearly 400,000 investors. The AFM imposed 6 administrative fines of 9, 075 Euros each on Bank A. These fines were imposed for misleading advertisements, wielding incorrect purchase and sale prices, cold calling, shortcomings concerning collecting information from the customer, shortcomings concerning written agreements with each client and shortcomings concerning administrative information systems and internal controls.

Some 100,000 investors with Bank A signed up to action groups arguing that they had never been properly told about the risks of investing in the share lease agreements. Investors pleaded that Bank A had insufficiently concerned itself with investors' investment objectives and experience, and that information given by Bank A on the advantages and risks of the share leasing products had been unbalanced. Bank A had, for example, paid insufficient attention to the risks, specifically the risk of a residual debt, and masked "interest payments" (a cost component) by calling them "deposits".

An out of court settlement agreement was made on 23 June 2005 between Bank A and certain interest groups regarding damages payable by Bank A to various classes of investors. The parties involved in the agreement appealed to Amsterdam's Court of Appeal under the Act on the Collective Settlement of Mass Damages (*Wet collectieve afwikkeling massaschade*) to declare this arrangement collectively binding. Around 200,000 Dutch investors are eligible for the arrangement. This appeal was confirmed in early 2007 and under the terms of the agreement investors are required to pay back only one third of the money they borrowed to invest in shares. Investors who are not in agreement with the arrangement were required to sign a so-termed opt-out statement by 31 July 2007; their separate appeal is as yet still unsettled. The financial cost to Bank A is large; it has already paid out over 1 billion Euros in damages. However it is its reputation that has been more severely impacted, as it has been forced to withdraw from business in the Netherlands completely.

Annex C

Members of the Working Group on Customer Suitability

Chairman	**Ian Johnston**	**Dubai Financial Services Authority**
Australia	Andrew Fawcett	Australian Securities and Investments Commission
Canada	Michel Hallé	Autorité des Marchés Financiers
France	Christine Decubre	Commission Bancaire
	Xavier Tessier/ Françoise Buisson	Autorité des Marchés Financiers
Germany	Ricarda Maier	BAFin
Italy	Riccardo Basso/ Aldo Stanziale	Bank of Italy
	Nicoletta Giusto	Commissione Nazionale per le Societa e la Borsa
Japan	Kazunari Mochizuki	Financial Services Agency
Netherlands	Rob Post	Netherlands Authority for Financial Markets
Spain	Elva Garcia Amigo	Bank of Spain
	José Manuel Portero	Comisión Nacional de Mercado de Valores
Switzerland	Andreas Achermann	Swiss Federal Banking Commission
United Kingdom	Tim Grange	Financial Services Authority
United States	John Connolly	Federal Reserve Board
	Gretchen Cappiello	Federal Reserve Bank of New York
	Kevin McCarty	Florida Office of Insurance Regulation
	Saul Carpio	Office of the Comptroller of the Currency
	George Lavdas	Securities and Exchange Commission
EU	Sarah Lynch	European Commission
IOSCO	Isabel Pastor	
Secretariat	Stéphane Mahieu	