21 May 2012

Mr. Stephen Po
Chairman, IOSCO Standing Committee 3 on
Regulation of Market Intermediaries
VIA E-MAIL

Dear Chairman Po and Members of IOSCO TC3:

Thank you for your invitation to participate in the TCSC3’s April meeting in Rio de Janeiro to discuss IOSCO’s proposed suitability requirements for the distribution of complex financial products, and for the opportunity to provide Financial Planning Standards Board’s (FPSB) preliminary views on your Committee’s draft principles. As discussed at the meeting, FPSB is now pleased to submit our public comments to the February 2012 consultation report, “Suitability Requirements with respect to the Distribution of Complex Financial Products.”

About FPSB

Established in 2004, FPSB is the global professional standards-setting body for the financial planning profession, and the owner of the CERTIFIED FINANCIAL PLANNER or CFP certification program internationally. Our members include 24 nonprofit organizations, representing more than 140,000 CFP professionals who work in a variety of disciplines, including banking, insurance, independent advisory services, securities and law. Within those sectors, CFP professionals work with millions of retail and non-retail clients in a variety of capacities, and in organizations that range from boutique practices to multi-national and global financial services firms.

FPSB’s vision is to establish financial planning as a distinct global profession, with the CFP marks as its symbol of excellence. Our mission is to benefit the clients and potential clients of financial planners by establishing, upholding and promoting worldwide professional standards in financial planning.

The CFP certification program provides financial service practitioners in a territory with global standards and program content for financial planning, localized to that territory. FPSB’s member organizations in 24 territories around the world localize and implement FPSB’s global standards to make them consistent with the laws, regulatory requirements and market practices in which CFP professionals conduct their business. CFP certification provides financial services professionals with a consistent foundation that includes a client-centric approach to providing financial advice, rigorous practice, experience and continuing professional development standards, and a global code of ethics, enforced by FPSB’s member organizations locally, that requires CFP professionals to place their clients’ interests first during financial planning engagements.

1 Financial Planning Standards Board manages, develops and operates certification, education and related programs for financial planning organizations to benefit the clients and potential clients of financial planners. FPSB has a nonprofit member organization in the following 24 territories: Australia, Austria, Brazil, Canada, Chinese Taipei, Colombia, France, Germany, Hong Kong, India, Indonesia, Ireland, Japan, Malaysia, New Zealand, the Netherlands, the People’s Republic of China, the Republic of Korea, Singapore, South Africa, Switzerland, Thailand, the United Kingdom and the United States. As of 31 December 2011, there were 139,818 CFP professionals worldwide. For more information, visit fpsb.org.
FPSB’s Perspective

FPSB defines financial planning as the process of developing strategies to assist clients in managing their financial affairs to meet life goals. Financial planning can involve reviewing all relevant aspects of a client’s situation across a large breadth of financial planning activities (including inter-relationships among often conflicting objectives). While products play a key role in the implementation of a financial plan, financial planners recommend products only after a financial plan is in place, and may refer their clients to other financial practitioners to purchase products. A financial planner’s recommended strategies may not always include the need to purchase or sell financial products.

As we did in our response² to the TCSC3’s questions on suitability in 2011, FPSB will respond to this consultation paper through the rubric of financial planning – a client-centric, process-driven professional practice that can help (re)build trust and restore consumer confidence in financial intermediaries – that can provide a context within which to evaluate the suitability of a financial product or service for clients.

While governments and regulators tend not to distinguish between the activities and oversight of those who provide limited advice and those capable of offering comprehensive financial planning, FPSB notes that, increasingly, regulators see a need for improved professionalism within the financial services sector. While FPSB welcomes enforcement of appropriate standards for the financial services marketplace throughout the spectrum of delivery models, we believe financial planners who voluntarily adhere to higher competency and ethical standards, who provide advice to clients with a fiduciary-like standard of care, and who comply with the obligations of being part of a professional community and belonging to a professional body, should be recognized for their contribution to increasing consumer trust and raising professionalism in financial markets around the world. FPSB considers professional certification an important tool to elevate the knowledge and to support the creation and enforcement of professional codes of conduct for financial intermediaries.

FPSB’s comments to “Suitability Requirements with respect to the Distribution of Complex Financial Products,” reflect the collective experience of FPSB and our 24 member organizations in developing professional competency, ethics and practice standards for the global financial planning profession. We welcome the opportunity to work cooperatively with the Committee in the development of guidance and principles to determine suitability and protect retail and nonretail clients during the sale of complex financial products. If you have questions, or would like additional information on FPSB’s response, please contact me at +1-720-407-1902, or nmaye@fpsb.org.

Best regards,

Noel Maye
Chief Executive Officer
Financial Planning Standards Board

Enclosure

² FPSB’s Response to IOSCO TCSC3’s Questions on Suitability, 31 May 2011.
FPSB’s Public Comments on “Suitability Requirements with respect to the Distribution of Complex Financial Products.”

**Principle 1:** Intermediaries should be required to adopt and apply appropriate policies and procedures to distinguish between retail and non-retail customers when distributing complex financial products. The classification of customers should be based on a reasonable assessment of the customer concerned, taking into account the complexity and riskiness of different products and services. The regulator should consider providing guidance to intermediaries in relation to customer classification.

According to the Joint Forum, the term “retail customer” is generally not defined. In its April 2008 report, the Joint Forum states that anyone who is not an “institutional” or “professional” investor (e.g., meets certain minimum net worth levels or is a corporation or trust) is generally treated as a retail customer, and that while suitability requirements apply to both, they may be applied differently.

FPSB believes it may be impossible to draw a “bright line” between retail and non-retail clients in a meaningful way when it comes to suitability for any product, regardless of complexity, because cognitive factors that are more difficult to identify could play a role in a customer’s decision-making process, whether that customer is considered retail or non-retail.

A European study conducted in November 2010 recognizes that while limited financial literacy or asymmetric information may contribute to a customer’s inability to make sound decisions about increasingly complex retail financial products, other factors, such as limited time to fully understand the products, processes of persuasion, personal interaction and trust play a role in decision-making. The report asserts that the formation of beliefs can be context-dependent and subject to framing effects or biases, such as overconfidence.

While TCSC3’s proposed Principle 1, and to a lesser extent, Principle 3, address retail clients, the rest of the proposed principles in “Suitability Requirements with respect to the Distribution of Complex Financial Products” seem to apply equally to retail and non-retail clients, which suggests IOSCO believes there should not be much difference in how retail and non-retail customers are treated. (The TCSC3 consultation paper does note that for some intermediaries, treating all customers as retail clients may be more cost-effective and affords a higher level of investor protection.) While FPSB believes all clients will benefit from principles and rules relating to suitability of products, and we accept that non-retail clients who need sophisticated investment or financial management strategies may knowingly opt out of certain protections, retail clients deserve to have the highest level of protections in place regarding duty of care, required disclosures and management of conflicts and IOSCO might want to consider providing some additional guidance to national regulators in this area. Additionally, intermediaries seeking to waive such protections for retail clients by re-classifying them as non-retail clients should have to meet significant and clearly defined regulatory requirements.

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Classifying a customer as retail or non-retail based on characteristics such as net worth, investment experience or previous exposure to complex products, may be misleading. A client’s wealth level is not a direct correlation to financial sophistication (think of the rural housewives association that won €4 million in the December 2011 “El Gordo” lottery in Spain), nor is a client’s sophistication level necessarily fixed or equivalent across all complex products. Implementing a general, “one-size-fits-all” classification for clients could inadvertently result in a client not being able to implement financial recommendations in the most effective manner.

**FPSB recommendations for Principle 1:**

- IOSCO should provide additional guidance to national regulators to assist intermediaries in making meaningful distinctions for the services and level of care that should be provided to retail and non-retail customers.

- When any doubt exists about a customer’s level of sophistication, intermediaries should default to a “retail” classification for customers, affording those customers the highest level of protection.

- Retail clients should always get advice around complex products (even if it’s limited), with a fiduciary-like level of care.

- Intermediaries should take customer suitability into account, regardless of the complexity of the product, because each customer’s level of sophistication could vary depending on the type of product being recommended or sold.

- Where intermediaries seek to classify a client as non-retail, or to shift a retail client’s classification to non-retail, the rationale needs to be clearly documented and supported by the intermediary and explained to the client.

**Principle 2:** Irrespective of the classification of a customer as retail or non-retail, intermediaries should be required to act honestly, fairly and professionally and take reasonable steps to manage conflicts of interest that arise in the distribution of complex financial products, including through disclosure, where appropriate.

FPSB agrees that intermediaries should always act honestly, fairly and professionally when dealing with clients, regardless of classification; however, consumers should always get advice around complex products (even at a limited level) with a fiduciary-like (client first) level of care. As a part of placing their clients’ interests first, advisers should manage conflicts of interest through disclosure, in writing. FPSB’s Model Rules of Conduct for CFP Professionals⁵ state that if the services include financial planning or material elements of the financial planning process, a CFP professional shall disclose certain information, including:

- An accurate and understandable description of the compensation arrangements being offered. This description must include information related to costs to the client and general form and source of compensation to the CFP professional and/or the CFP professional’s employer; and terms under which the CFP professional and/or the CFP professional’s employer may receive any other sources of compensation, and if so, what the sources of the payments are and on what they are based; and

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• A general summary of likely conflicts of interest between the client and the CFP professional, the CFP professional's employer or any affiliates or third parties, including, but not limited to, information about any familial, contractual or agency relationship of the CFP professional or the CFP professional's employer that has a potential to materially affect the relationship with the client.

Research\(^6\) shows that nearly 80 percent of investment decisions are made in a face-to-face setting, usually with an employee of the investment provider or a professional adviser. In many cases, conflicts of interest are disclosed verbally, causing investors to disregard or not think about the information provided. The research found that the impact of disclosing conflicts of interest was context-dependent. Online subjects in the research cited, for example, who were only told that their adviser was paid a commission, didn’t react to the disclosure unless it was accompanied by a “health warning.” Laboratory subjects responded to disclosure without a health warning when they received exact details of their adviser’s remuneration structure.

**FPSB recommendations for Principle 2:**

- Advice around complex products (and, for that matter, any product) should be given with a fiduciary-like standard of care.
- Intermediaries should disclose conflicts of interest in writing, using plain and simple language. Disclosure should include sources of remuneration, as well as the intermediary’s role (if any) in the design and distribution of the product(s) recommended.
- IOSCO should provide guidance to national regulators as to where and when disclosure is appropriate, and as to the fullness and transparency of the disclosure, keeping in mind that the context in which a disclosure is made could influence a customer’s reaction to the disclosure.

**Principle 3:** Investors should receive or have access to material information to evaluate the nature, costs and specific risks of the complex financial product. Any information communicated by intermediaries to their customers regarding a complex financial product should be communicated in a fair, comprehensible and balanced manner.

Carlin\(^7\) found that complexity preserves market power and corporate profits by bounding the financial literacy of consumers. Bernard and Boyle\(^8\) also found that retail investors did not have the expertise to understand the complexities of contracts, and obtained advice from an agent who received a sales commission. If the manufacturer’s surplus was shared with the sales agent, then incentives existed for the agent to push more complex products, and for the industry to favor a regulatory regime that makes it easier to avoid disclosure and complicate the product. Therefore, it would seem that simply receiving or having access to material information evaluating the risks of a complex financial product is not enough to protect the customer. The customer also needs to understand the context in which the product is being recommended (including a rationale for why the complex product is preferred over a simpler product) and how the compensation structure for the intermediary and manufacturer compares to other similar products.

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\(^6\) Chater et al


“Fair,” “comprehensible” and “balanced” should be characteristics of communication regarding any financial product, whether simple or complex. However, simplifying and standardizing product information has also been shown to be beneficial to customers. Chater et al found that standardizing and reducing the amount of information helped subjects identify the optimal choice between similar investments, and that providing comparable, pre-calculated information on the next expected value of each investment helped subjects identify the optimal choice between dissimilar investments.

Information after the sale should also be considered. As FPSB sought feedback on these nine principles from our member organizations and CFP professionals, we received the following feedback from Patrick Canion, a CFP professional practicing in Australia:

“Here in Australia, I have seen many instances where a complex financial product was launched and marketed to us, and through us, to our clients. However, several years into a (say) five or seven-year term, it is almost impossible to get information from product manufacturers. The more complex the product, the harder it is to get information.”

Taking Mr. Canion’s experience into account, it would appear that Principle 3 should not just consider communication between intermediary and customer, but also between product manufacturer and intermediary. Mr. Canion, in his feedback to FPSB, suggested that once an investor is “locked in,” there is no incentive for ongoing communication from the product manufacturer to the intermediary.

FPSB recommendations for Principle 3:

- Material information provided to the customer should also include context for the recommendation, including why the product is preferred over a comparable, simpler product (if applicable), how the product will meet the needs of the client, and how both the intermediary and product manufacturer will be remunerated.

- Regulators should consider standardizing the type and format of the information they believe customers need to have to make optimal choices between investments, further requiring such information to be in “plain and simple” language.

- Product manufacturers should be addressed in Principle 3 as part of the chain of communication to the customer, directly and through intermediaries.

Principle 4: Even when an intermediary sells to a customer a complex financial product on an unsolicited basis (no management, advice or recommendation), the regulatory system should provide for adequate means to protect customers from associate risks.

FPSB supports the MiFID approach to protection of customers for non-advisory services, and recommends that customers (retail and non-retail) receive advice, even if the advice is limited, with a fiduciary-like standard of care from intermediaries who are offering complex financial products.

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9 Chater, et al.
**Principle 5:** Whenever an intermediary recommends to a customer that it purchase a particular complex financial product, including where the intermediary advises or otherwise exercises investment management discretion, the intermediary should be required to take reasonable steps to ensure that recommendations, advice or decisions to trade on behalf of such customer are based upon a reasonable assessment that the structure and risk-reward profile of the financial product is consistent with such customer’s experience, knowledge, investment objectives, risk appetite and capacity for loss.

FPSB supports this principle, and recommends adding a stipulation that the intermediary should document and disclose the method(s) used to arrive at the recommendation and record how the product recommendation links to the client’s identified needs.

**Principle 6:** An intermediary should have sufficient information in order to have a reasonable basis for any recommendation, advice or exercise of investment discretion made to a customer in connection with the distribution of a complex financial product.

Principle 6 assumes that intermediaries have access to sufficient information on which to base their recommendations, advice or exercise of investment discretion, but product manufacturers have a role to play in ensuring that they communicate information in an easy-to-understand format to intermediaries. US-based CFP professional Mark DiGiovanni provided the following feedback to FPSB:

“To understand the product, we need to know all its components and how they interact with each other. We also need to know how external factors can affect the components and how those external factors affect the interaction of the components. Many of these products are so complex and hard to understand that only their designers truly know how they work. The wholesalers who are pushing advisers to use them rarely know all they need to know, so it’s highly unlikely that a financial adviser will have adequate knowledge. And in those rare cases where an adviser has adequate knowledge of a complex financial product, the likelihood for even a sophisticated investor to understand it properly is slim. Considered another way, if the wholesaler understands the product half as well as its designer, if the advisor understands the product half as well as the wholesaler, and if the client understands the product half as well as the adviser, there’s about a 12 percent chance that the client will adequately understand the product.”

Also, as part of determining suitability, intermediaries should consider, in addition to any particular financial product, the impact that product would have on an individual’s portfolio. That is, purchase of a complex financial product which amounts to a miniscule percentage of an investor’s portfolio would have far less potential impact than if the same purchase constitutes a majority position in a portfolio. If this is true, then part of determining suitability should include an exploration of the customer’s overall portfolio. This exploration should be made within the context of the customer’s goals and objectives, risk profile, risk tolerance, and the balance between these and the purchase of any new product.

Intermediaries should also consider, and explain to customers, the potential impact of endogenous risk, especially when considering the purchase of a complex financial product. Endogenous risk comes from aberrations and shocks that are generated within the financial system itself, which then have a ripple effect throughout the financial markets.10 (Pasztor)

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The experience of Lehman Brothers, and others, shows that while endogenous risk can hurt a “plain vanilla” portfolio, it will almost certainly have a more detrimental impact on any portfolio holding more complex investments (e.g., Lehman mini-bonds, credit default swaps, etc.). That these investments are complex, and thereby all the more difficult to evaluate and understand, points to the need for financial intermediaries to provide extra care and due diligence when recommending them, especially to the retail customer.

FPSB acknowledges the limited scope of this working group in terms of its focus on intermediaries within the “suitability” chain, and that a separate IOSCO working group is examining the obligations of manufacturers of complex financial products. However, FPSB believes it is critically important that the work of these two groups come together at some stage prior to the finalization of these principles, as ultimately, whether and how intermediaries will behave and can comply with these Principles, and the protections they will afford retail and non-retail clients, will depend on the obligations and oversight placed on the manufacturers of complex financial products by regulators.

A discussion of suitability requirements for the distribution of complex financial products must start at the manufacturer level, with a discussion around the product’s ideal buyer, the product’s construction (was it well made?), whether it is “true to purpose” (does the product fulfill the purpose for which it is intended or publicly promoted?), and the critical points that need to be explained, both to the intermediary and the end customer. As FPSB noted in its May 2011 comment on this topic, in a 2007 article in Democracy, Chair of the Congressional Oversight Panel overseeing the U.S. banking bailout, Elizabeth Warren, noted that regulation and oversight of consumer products in the US made it “impossible to buy a toaster where one in five can burst into flames and burn down the house,” but such protections were not extended to retail consumers who owned a mortgage and wished to be able to stay in their homes. It has been documented that some complex financial product manufacturers knowingly or unwittingly, built “financial weapons of mass destruction,” and left retail investors scrambling to pick up the pieces after the explosions.

Regulators need to impose tighter control over how complex products are designed, branded and marketed to retail clients, and to ensure that all complex financial products meet the purpose for which they were both designed and promoted. This approach can already be found in elements of the UK and South African Treating Customers Fairly initiatives. In addition to requiring manufacturers to provide clear guidance to intermediaries on how to comply with regulations and requirements to advise on and sell complex financial products, at least for products available to retail clients, regulators should require nomenclature and descriptors (including an explanation of extreme outcomes associated with the product) that would clearly signal to retail clients the nature and purpose of the complex financial product.

There is an opportunity for IOSCO to encourage national regulators to introduce an easy-to-understand system for Rating of Complex Financial Products, and to shift from broad guidance to the markets on complex financial products to providing product-specific guidance to retail investors that rate the complex products in terms of their risk potential. While FPSB acknowledges that the costs associated with reviewing and rating all available complex financial products is prohibitive, national regulators are familiar with which products have caused the most damage to retail clients and could start this process by focusing on those products and future generations of those products.

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11 Unsafe at Any Rate, Elizabeth Warren, Democracy - A Journal of Ideas, Issue #5, Summer 2007
FPSB recommendations for Principle 6:

- Product manufacturers should be required to provide sufficient information to intermediaries in an easy-to-understand format that enables intermediaries to develop their recommendations for customers. Where product manufacturers do not do this, intermediaries should be prohibited from recommending those products.

- Intermediaries should include in their recommendations to the customer, the potential impact of endogenous risk, particularly when considering the purchase of a complex financial product.

- Regulators need to start enforcement of suitability principles at the manufacturer level, with tighter control on how complex products are designed, branded and marketed to retail clients.

- Regulators should develop a commodity-specific nomenclature and risk-rating system to bring further clarity to their guidance on complex financial products.

**Principle 7:** Intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability obligations, including when developing or selecting new complex financial products for customers.

In January 2012, FINRA issued a regulatory notice that provided guidance to firms in the US around products that may need heightened supervision or compliance procedures, and provided examples of procedures that could be appropriate. FPSB supports this approach, and believes that professional bodies and SROs could also assist in providing a set of best practices or duty-of-care principles around complex financial products.

FPSB recommendations for Principle 7:

- When two broadly similar products are available, with one being complex and the other “plain vanilla,” the intermediary should be encouraged to select the simpler product.

- Alternatively, if a customer is offered a complex product when a roughly equivalent simple product exists, intermediaries should be required to prove that the complex product was the only or best option that met the customer’s objectives.

- Regulators should develop guidance around compliance for selling or advising on complex financial products, and work with professional bodies and SROs to develop best practices for intermediaries.

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

FPSB supports Principle 8, but because many incentive programs start at the manufacturer level, FPSB recommends that regulators consider tightening control over incentives and disclosure around incentives.

**Principle 9:** Regulators and self-regulatory organizations should supervise and examine intermediaries on a regular and ongoing basis to help ensure firm compliance with suitability and other customer protection requirements relating to the distribution of complex financial products. Enforcement actions should be taken by the competent authority, as appropriate. Regulators should consider the value of making enforcement actions public in order to protect investors and enhance market integrity.

FPSB supports Principle 9, and similarly requires FPSB member organizations to establish both a complaint process and a disciplinary process for CFP professionals. In FPSB Member territories where privacy laws permit, we encourage making enforcement actions public. News releases around enforcement activities are frequently reported in the media, and help to enhance the integrity of CFP professionals with clients.