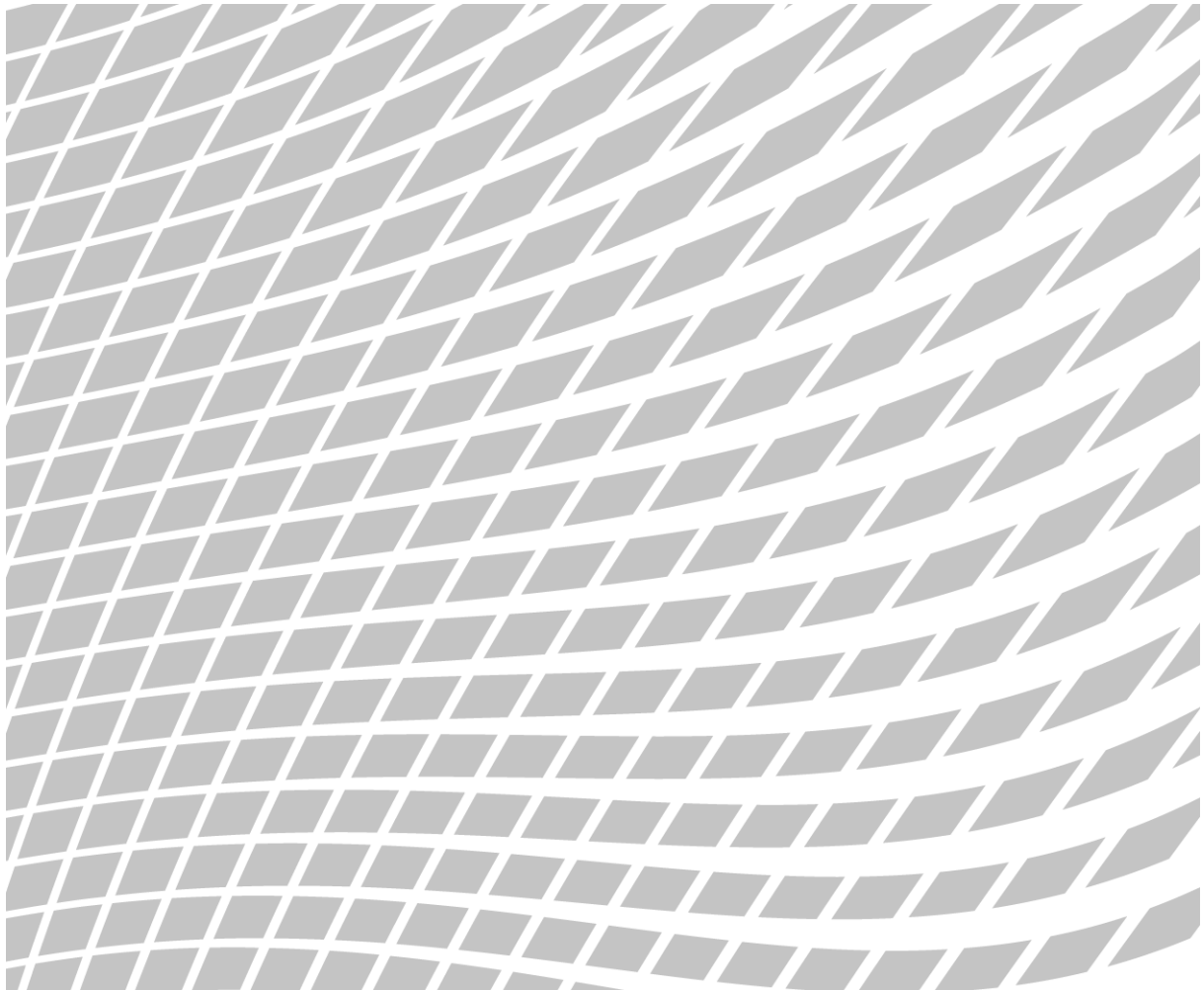


10 November 2010

Key points

“FINMA Distribution Report 2010”



Based on its strategic goals and the findings of the investigations into the Madoff and Lehman affairs...

One of the targets published by FINMA in September 2009 is to improve the protection of clients in the Swiss financial market. It should also promote appropriate, product-neutral due diligence, disclosure and information requirements in the marketing of financial products, with the focus initially on information on the risk profiles of financial products, i.e. the likelihood of gain or loss associated with the purchase (or subsequent disposal) of a product. FINMA published the findings of its investigations into the Madoff and Lehman affairs in March 2010, concluding that the risk profile of the financial products was not always aligned with the risk profile of the clients. In some cases, clients' risk awareness and willingness to take risks were not clarified properly, and insufficient account was taken of clients' personal capacity to take risks.

...FINMA launched a cross-sector "Distribution rules" project...

Under the "Distribution rules" project, FINMA investigated on a cross-sector basis and taking account of international and foreign legal developments whether the existing product, conduct and distribution rules ensure that clients are adequately protected. The project also looked at rules on remuneration, cross-border distribution from other countries in Switzerland and supervision of intermediaries. In particular, FINMA considered whether any differences in the regulation of different product types or services were justified and whether there was a need for regulation. In so doing, it built on the work of its predecessor institutions and its own supervisory activities, but also held workshops with representative financial services providers and industry organisations and consulted ombudsmen and consumer organisations. Existing production and distribution processes were set out and possible improvements discussed.

...analysing financial products and services for retail clients...

The marketing of products and provision of services to retail clients was at the heart of FINMA's research and analysis. For FINMA, the term "retail clients" refers to clients that usually have average income and wealth levels and whose knowledge of the financial markets tends to be fairly limited. It does not include professional asset managers, proprietary traders, etc. or large institutional clients such as pension funds, insurance companies and fund managers. Based on the competencies assigned to it by law, FINMA limited its considerations to its own sphere of supervision. In addition to the Swiss Financial Market Supervision Act, this sphere is defined by seven sector-specific financial market acts, namely the Banking Act, the Insurance Supervision Act, the Insurance Contract Act, the Stock Exchange Act, the Collective Investment Schemes Act, the Mortgage Bond Act and the Anti-Money Laundering Act. Notable exclusions included (consumer) credit and mortgage products (which can also be considered financial products). The investigation did, however, include market participants that are not (yet) subject to prudential supervision by FINMA.

...and examining the value chain and legal environment.

The value chain for financial products consists for the first part of the production of products and their distribution, be that through an internal marketing force (direct distribution) or external distributors used as intermediaries (push side). The other side of the coin at the point of sale or point of purchase is the client who has bought financial products (pull side) and later trades in them. Whereas production has to contend with all matters relating to the creation of products, distribution is responsible for placing the finished product on the market and bringing it to the target group in question. Clients either make their investment decisions alone and then commission a third party to execute the transaction (execution only), obtain advice from investment advisors before making their decisions or delegate both the decisions and execution to an asset manager by means of a power of attorney. The rules that financial services providers are subject to vary depending on their activity and the financial product. As such, differing regulatory requirements apply to an institution's conduct when marketing financial products. The legal provisions on the supervision and control of such rules of business conduct are inconsistent. Furthermore, Swiss supervisory law does not provide for a licensing or approval procedure applicable to all products, and the prospectus requirements also vary between different types of financial products.

FINMA has identified a considerable information gap and a power imbalance between financial services providers and retail clients...

Retail clients often have only limited knowledge and experience of financial investments and poor access to the necessary information. Firstly, they lack the experience to reliably assess their own financial needs and capabilities from a long-term investment perspective. Secondly, they lack the time, motivation and means to familiarise themselves with the subject. They then come up against professional financial services providers, particularly product providers and distributors, that do have the requisite specialist knowledge to adequately weigh up the opportunities and risks associated with a transaction. In addition, product creators and people associated with them generally have a better idea than potential clients of how a given product is designed. Other problem areas are the pressure on providers to bring in revenues and the increasing complexity of financial products. In some cases, products were not sufficiently understood not only by clients, but also by the distributors themselves. The opportunity for returns was sometimes emphasised in isolation, while costs and risks were downplayed. Consequently, some products found their way into retail clients' holdings that were unsuitable or not fully suitable for realising the clients' investment objectives paying due regard to their risk capacity. Poor decisions of this kind were also encouraged by short-term thinking on the part of financial services providers and excessive demands and credulity on the part of clients. Retail clients are not always conscious of differences in the regulation of different kinds of products and financial services and regularly assume that financial services providers are solely pursuing clients' interests when marketing products, which is not – or at least not always – the case.

...which are not adequately levelled out by the laws in force.

Financial market regulation, with its focus on the protection of savers and other depositors, policy holders and investors on the markets in which these participants invest in investment products, does

tackle these problem areas in some respects, but in FINMA's view such efforts are inadequate and not homogeneous. Differences in the regulation of financial products that are substitutable for one another would only make sense if the discrepancies could be justified by the intended objectives of the regulation. However, that is not true in this case: in FINMA's opinion, the existing requirements for investment products are not sufficient to make retail clients in particular adequately aware what kind of product they are buying and what the likely returns, losses and risks associated with it are. In some cases, prospectuses or product descriptions do not make it sufficiently clear to retail clients who the actual counterparty is. The applicable law at the point of sale merely lays down isolated duties for service providers to get and provide information in relation to client needs. Clients cannot be confident for all products and all financial services providers that advice has been given or that the advice given reflects their personal investment objectives, knowledge and financial circumstances and that they have been adequately informed of the risks inherent in a particular transaction or the associated costs, taxes, etc. Nor is there an adequate obligation to disclose own interests and conflicts of interest, for example distribution compensation. In FINMA's view, it is also inequitable that some financial services providers are not subject to any registration requirement under the law as it stands, but are able to provide their services entirely free from any supervisory standards. In disputes, clients are regularly faced with the burden of proof, which hinders their client relationships from being redressed in civil lawsuits. Finally, there are major differences in client protection against cross-border providers from other countries, as the approaches under the various financial market acts vary considerably without compelling reason.

FINMA is therefore promoting discussion on the subject of enhancing client protection by...

Although FINMA believes it would be desirable to improve the financial literacy of retail clients, even intensive education measures would hardly be able to bring this to a long-term level where clients become largely independent of the conduct of the service provider at the point of sale. For this reason, FINMA is sceptical about programmes to educate clients in financial matters. It is instead proposing an array of regulatory measures for discussion.

...firstly, expanding duties to produce a prospectus and notification duties at product level...

To begin with, there is a need at product level to extend the requirement to produce a prospectus for investment products, in a way which is coherent and largely product-neutral. Prospectuses should be written in plain language and include all material (and accurate) information on product characteristics, potential for returns and losses, risks associated with the product, its legal status and the typical investor profile. In the interests of improved comparability, standardised, product-neutral information on the key characteristics of complex financial products should also be stated (product description). Appropriate follow-up publications should also be assured for the products in question. Tackling the issue at product level has the advantage that the creators of a product naturally have the greatest understanding of how that product is designed. Conversely, distributors dealing with clients at the point of sale are best able to judge questions concerning the suitability and appropriateness of a financial product in each specific situation following consultation with the client.

...secondly, strengthening and harmonising rules of business conduct at the point of sale...

FINMA regards the introduction of harmonised or at least more consistent rules of business conduct for all financial services providers at the point of sale as a central element in addressing the shortcomings and weaknesses of the applicable law. In particular, financial services providers must be subject to coherent duties to get and provide information in relation to client needs. Potential and actual conflicts of interest and third-party remuneration must be systematically disclosed. In formulating these obligations, a distinction must be drawn between advisory and asset management activities and straight sales or execution activities. Entities that undertake investment advisory or mandate-based asset management services for clients must be required to carry out a suitability test before performing the service. If a client does not receive any personal advice on a particular product or financial service and no asset management activity takes place, an appropriateness test would have to be carried out as a minimum. In the case of straight execution-only transactions in which the service provider solely executes the transaction at the point of sale without providing the client with any information on the specific product or approaching the client with the product, the obligation to conduct an appropriateness test could even be waived if the client is informed of this in advance.

...thirdly, improving transparency at the point of sale...

Retail clients must be protected not only against products that are unsuitable for them but also against unrealistic expectations of the counterparty when a financial product is bought or a financial service is used. As discussed above, retail clients regularly assume that financial services providers are solely acting in clients' interests when marketing products. The service provider must either live up to this expectation at the point of sale or correct the assumption before the transaction takes place. It must be clear to the counterparties before a financial service is performed what the performance obligations under the contract in question are. As such, the service provider must explain his or her own role to the client and provide the client with information on the company and his or her own qualifications before a contract is concluded. An in-depth explanation of products and investment strategies and of the costs, taxes, etc. associated with a specific transaction is also required. Finally, introducing documentation requirements could greatly simplify the demonstration of liability in civil lawsuits. It would be conceivable, for example, to bring in a documentation requirement for the client's risk profile, to include the reasons that led to a specific recommendation to that client (product risks, return potential, costs, etc.). Another possibility would be standardised recording of advisory and purchase discussions.

...fourthly, bringing in stricter and more consistent regulation of cross-border distribution of foreign financial products in Switzerland...

There is a need for a coherent, product-neutral approach to the regulation of the cross-border offering from other countries, under which clients in Switzerland would receive the necessary level of protection irrespective of the product category or service in question. The fact that in Switzerland cross-border cold calling by banks and securities dealers from other countries is not subject to regulation is unusual by international standards and a questionable state of affairs. The same is true of the absence of any licensing requirement for cross-border advertising in relation to public deposits.

...fifthly, adopting client segmentation...

Introducing the measures outlined so far would in some cases entail high implementation costs for financial services providers, which experience has shown tend to be passed on to clients. As no regulatory measures should be brought in without the benefits justifying the expense that is caused, FINMA is advocating the introduction of product-neutral client segmentation into qualified and standard clients (mirroring the EU Prospectus Directive and MiFiD). Although also professional clients regularly require a certain degree of protection, they are well able to obtain relevant information for themselves and use any market power they have in dealings with financial services providers. The proposed measures could therefore be significantly watered down for qualified clients. It would be conceivable, for instance, to limit the requirement to produce a prospectus to financial products that will be distributed solely or partly to common investors. Client segmentation could also be applied to rules of business conduct at the point of sale, with the proposals outlined above applying only to common clients. It might also be possible to allow clients to choose which category they belong to (opt-in or opt-out).

...sixthly, bringing in rules of business conduct and a registration requirement for financial services providers that are not subject to prudential supervision...

Requirements in terms of training and experience should be introduced for persons responsible for providing financial services (including within the prudential sphere). A suitable registration requirement is also needed for financial services providers that are not subject to prudential supervision, to include checks on compliance with the new rules of business conduct. Clear designations for financial services providers are another proposal. There must be no ambiguity for clients as to whether a provider is subject to prudential supervision (mainly in the case of banks, insurance companies, securities dealers and fund managers) or merely to registration. Provided that sufficiently high standards are observed, it should be possible for Swiss providers to submit voluntarily to supervision in order to facilitate cross-border provision of financial services.

...and seventhly, bringing in an ombudsman's office with the power to make rulings for all financial services providers.

Retail clients in particular would benefit from the introduction of a single dispute arbitration mechanism (ombudsman's office) applicable to all producers and other financial services providers in the Swiss financial centre. This would enable clients to speak to someone outside the service provider in question in the event of queries or anomalies. Creating an independent ombudsman's office for all financial services providers in the Swiss financial centre could also save retail clients from having to take costly and risky legal action against their contractual partners at the point of sale. Local offices could be set up (particularly for the different language regions), but the ombudsman's role should be clearly based on a single set of cross-sector articles of association. In order to ensure effective dispute resolution, the ombudsman's office could also be awarded the power to rule on disputes. The possibility of collective dispute settlement for comparable cases affecting a large number of retail clients in a similar way would also be welcome.

Implementation of these proposals will require supervisory measures by FINMA...

FINMA's objective is to address certain shortcomings that have been identified by means of existing legislation, as far as this is within its powers. Within the limits of its supervisory remit and its resources, it will therefore look in depth at compliance with existing rules of business conduct at the point of sale and take enforcement action where necessary. In particular, spot checks on the simplified prospectuses for structured products are a possibility. FINMA is also considering other steps including mystery shopping to check the quality of financial services providers.

...a new Financial Services Act and potentially an interim Ordinance on Rules of Business Conduct...

FINMA is also proposing for discussion a general Financial Services Act to entrench for the long term the courses of action that it is advocating. However, experience has shown that even with clear political backing, it takes several years to bring such a legislative project to the point of entry into force. It would be faster, and therefore necessary, to implement a Federal Council Ordinance on Rules of Business Conduct in securities trading and the distribution of collective investment schemes, even though this would be limited to certain financial services providers already subject to prudential supervision.

...in order to enhance client protection and Switzerland's attractiveness as a financial centre.

FINMA is confident that implementing its advocated courses of action would make a positive contribution to strengthening the protection of clients and of Switzerland's reputation, while also boosting the country's attractiveness as a financial centre. The measures could also help improve access to foreign markets.