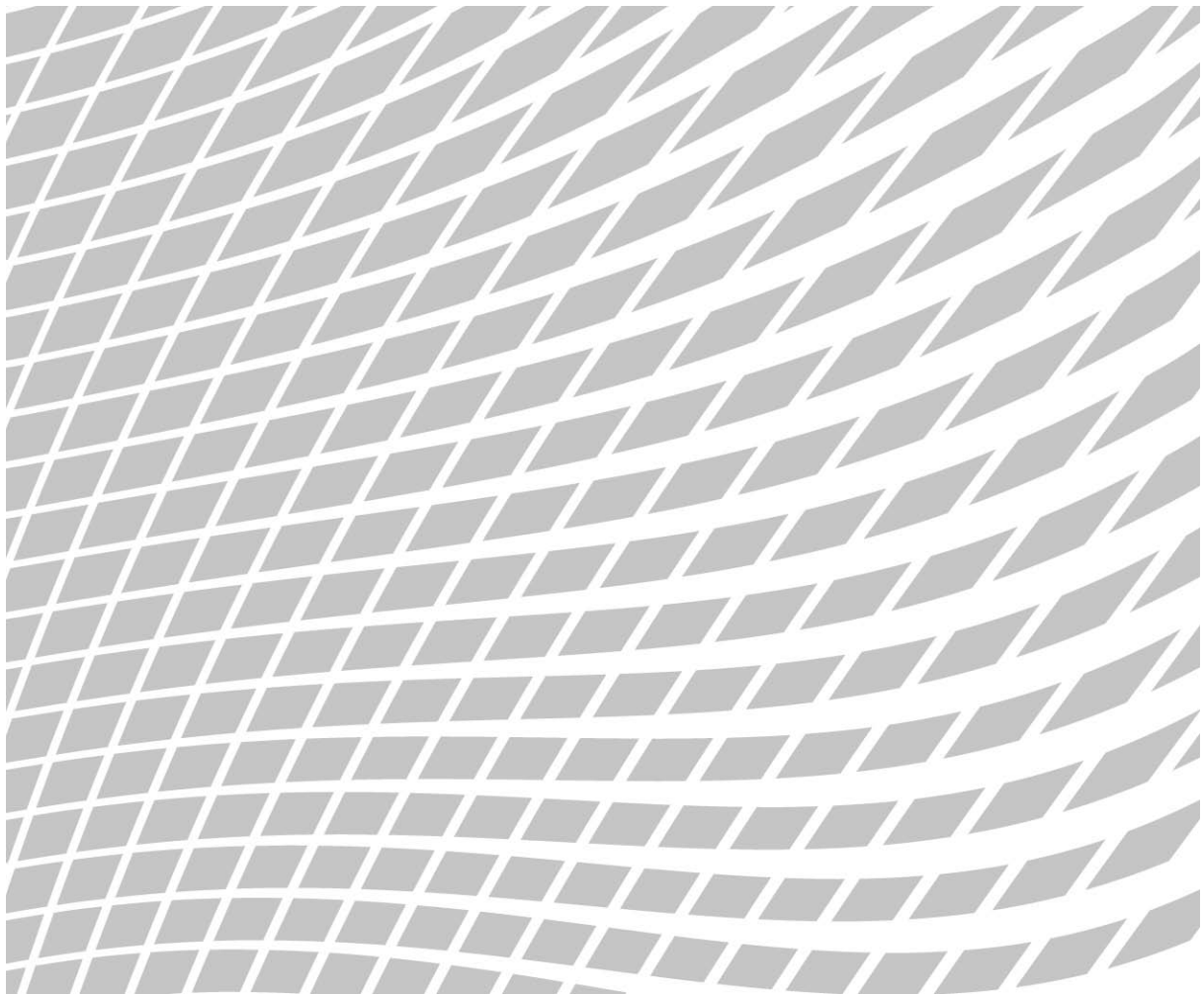


2 March 2010

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## **Madoff fraud and distribution of Lehman products: implications for investment advisory and asset management business**

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## Key points

- 1) FINMA completed two large-scale investigations in 2009. The first concerned the impact on Switzerland as a financial centre of the major fraud committed in the USA by the US investor Bernard L. Madoff. The second looked at the distribution by Swiss financial intermediaries of structured products that were guaranteed by subsidiaries of Lehman Brothers Holdings Inc.
- 2) Both investigations confirmed that investors had suffered losses on financial products, paying the penalty for risks that were known, but were widely perceived as negligible. Ultimately, the only way to counter this is through sufficiently broad diversification. Whereas qualified investors made up the bulk of those affected by the Madoff affair, many retail clients had bought capital-protected structured products issued by the Lehman Group.
- 3) On the basis of the findings of the investigations, FINMA is of the opinion that the applicable legislation does not adequately protect investors and that there is a need for regulatory action. It has therefore launched a “Distribution rules” project aimed at drafting proposals for regulatory changes by the legislators and Swiss Federal Council and at flagging up areas where FINMA should take regulatory action itself. The following areas will be covered: distribution rules and codes of conduct, rules on remuneration, product rules, rules on cross-border distribution in Switzerland, rules on the supervision of intermediaries and the regulation of conflicts of interest where primary market transactions are executed on a commission basis. There will be a particular focus on how the return potential and risk of loss of financial products can be transparently conveyed, on the diligent determination of (investment) clients’ risk capacity and awareness and on the question of adequate diversification for investment advisory and asset management clients.
- 4) Aside from the need for action described above, FINMA identified in the Madoff investigation a need for corrections to internal processes at certain financial intermediaries and has ordered the necessary measures.
- 5) The impact of the bankruptcy of the US Lehman Group on Switzerland related above all to the almost total loss of value of capital-protected structured products from an issuer in the Lehman Group. The investigation found that the question of who exactly issued a chosen product was not generally a decisive factor in clients’ investment choices. There was virtually no difference in clients’ minds between issuers with comparable ratings. According to FINMA’s findings, the prospectus required for unlisted structured products under Art. 5 of the Swiss Collective Investment Schemes Act is not a factor in client advisory services. FINMA also concluded that capital-protected structured products are suitable for distribution to retail client and that accusations cannot be made against individual banks for offering such products to their clients. At the same time, however, the investigation found that the applicable regulation does not (any longer) adequately govern the rights and obligations of the contracting parties in investment business. A review of the supervisory and legal framework in relation to investment advice is therefore needed.

- 6) In spring 2009, FINMA launched proceedings against Credit Suisse in connection with the distribution of Lehman Group capital-protected structured products. These proceedings were terminated at the end of 2009. FINMA concluded that the bank had treated its client and proprietary portfolios in exactly the same way and that the remuneration earned by its investment banking arm was in line with market levels. The sales documentation used by the bank referred to the issuer risk entailed in purchasing the product, although not very prominently (this has changed since the Lehman Group bankruptcy). Commensurate corrective action has now been taken. There was no objection from a supervisory perspective to “white labelling”, where only the seller’s own logo is used on the sales documentation for products of another issuer.
- 7) Credit Suisse made mistakes in its provision of advice in certain cases, but taken as a whole they do not justify special supervisory measures. Credit Suisse has of its own volition made offers to a large number of clients to bear part or all of their losses, having chosen not to go down the route of a case-by-case examination. The civil courts are responsible for ruling on disputes in relation to the purchase of Lehman Group capital-protected structured products.