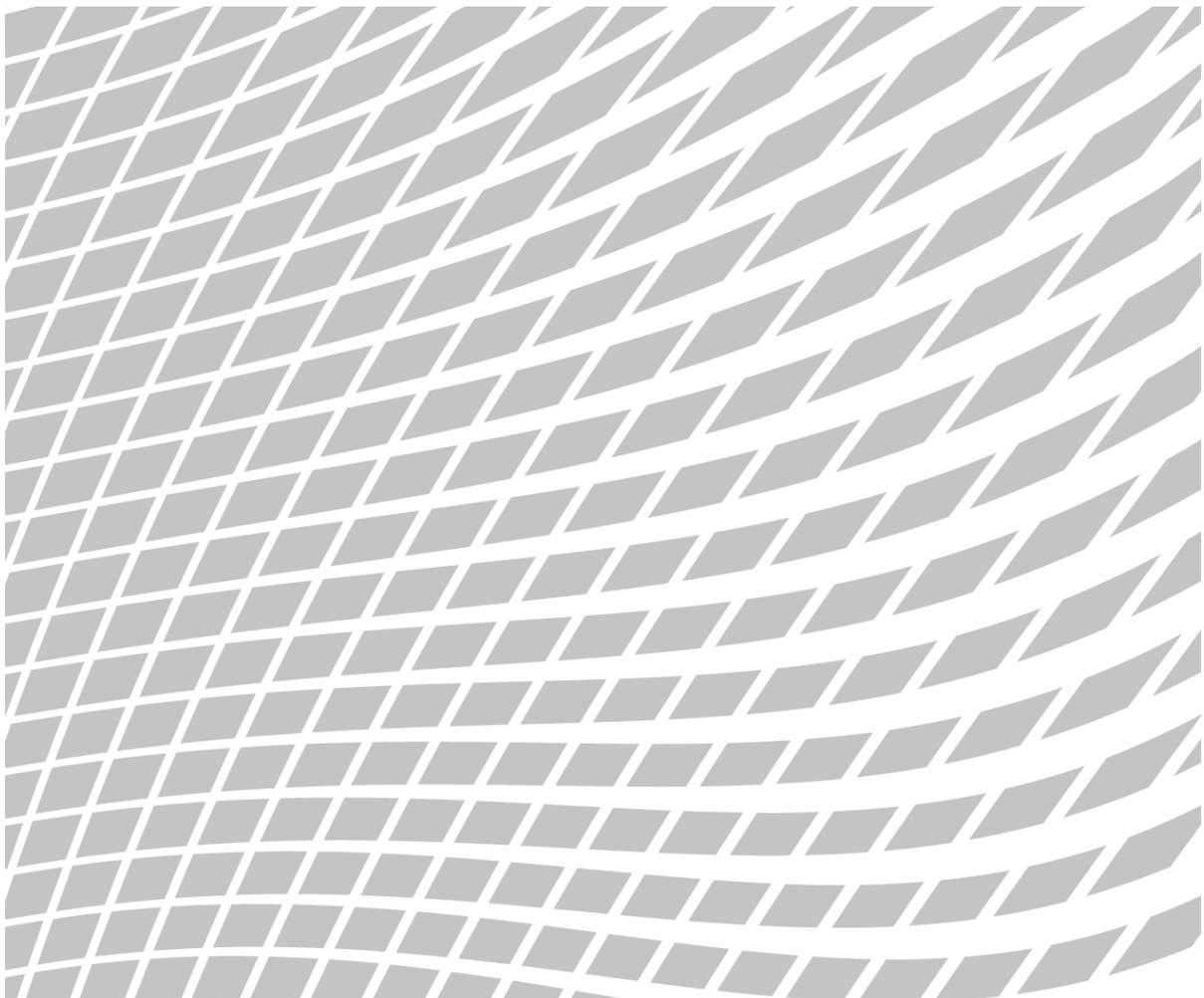


9 December 2011

Spot checks of simplified prospectuses for structured products



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1 Key points

FINMA checked around a hundred simplified prospectuses, which are required by law for the sale of structured products, from a representative selection of major market participants. The investigation focused on compliance with the requirements in terms of labelling, product risks, profit and loss prospects as well as the ease of understanding and structure of the prospectus.

The main findings are as follows:

- The quality of prospectuses varies considerably between institutions. There are both good and bad examples¹. Only two of the 11 institutions investigated are in full compliance with all the prospectus requirements. The majority show deficiencies in the structure of their prospectuses and the ease with which they can be understood. In addition, the rules on labelling are not being complied with to a satisfactory degree.
- The simplified prospectus tends to play only a secondary role in the advisory process. Most distributors use their own sales documentation at the point of sale instead.
- The various issuers take extremely different approaches as regards the presentation of their prospectuses. With the exception of the product description (key data), investors have very little scope for comparing structured products on the basis of the simplified prospectus.
- Most of the simplified prospectuses that were checked are not easy to understand. They are often too long, too technical in their wording, not structured in a uniform manner and lacking in explanatory scenarios and charts. In particular, prospectuses published in English are very difficult for the average investor whose first language is not English to understand.
- By and large, prospectuses list and explain the significant risks in full.
- None of FINMA's checks revealed any evidence of sanctionable violations of the prospectus rules. There is no need to follow up the checks with enforcement procedures, and FINMA can ensure that the deficiencies it identified in the content of prospectuses are rectified through its usual supervisory channels.
- FINMA does not believe that the rules currently in force offer buyers of structured products sufficient protection. The regulatory basis must be improved.

2 Background and aims of the short report

In 2010, FINMA initiated a project to review the existing distribution rules across the different sectors. It was to determine in particular whether the existing product, conduct and distribution rules offered sufficient protection for clients. The project was triggered by a number of factors. These included FINMA's investigations into the bankruptcy of Lehman Brothers Holdings Inc. in autumn 2008, which

¹ Current simplified prospectuses for listed structured products offered for sale in Switzerland can be found at www.payoff.ch/product/issuer-matrix.html or www.scoach.ch/DEU/produkte/neue_suche.

found no serious violation of the applicable Swiss supervisory laws by issuers or distributors but clearly demonstrated that the current rules do not sufficiently protect investment advisory and asset management clients. FINMA published the findings of the cross-sector review in its discussion paper “FINMA Distribution Report 2010”.

This report also contains FINMA’s statements on the prospectus requirement for structured products under Article 5 of the Collective Investment Schemes Act (CISA)². FINMA pointed out that compliance with the rules as per Article 5 CISA was repeatedly subject to debate and criticised the fact that many simplified prospectuses fell short of the legal requirement that they be easily understood. FINMA announced that it would carry out spot checks of simplified prospectuses within its sphere of supervision to verify that they are complying with the law.

In this respect, FINMA has neither the supervisory remit nor the power to subject prospectuses to a general preventive check, but it can check their compliance with the supervisory law framework among supervised market participants.

Between July and October 2011, random samples were collected from 11 market participants to check that they are complying with the prospectus requirement for structured products. The review is representative for the Swiss structured products market. This short report presents the findings and conclusions of the spot checks regarding the simplified prospectus and highlights the weaknesses found.

3 Content and scope of the checks

Random samples were collected such that the main types of structured product in demand among investors (capital protection, yield enhancement and tracker) were covered³. FINMA chose ten products at random for each issuer or distributor and analysed the corresponding prospectuses⁴. FINMA also asked the banks questions about the significance of the simplified prospectuses, any other documents used for distribution purposes and the number of listed and unlisted products during the investigation period.

The banks analysed were primarily chosen on the basis of their market share in the issuance and distribution of structured products in Switzerland. FINMA also took care to ensure that institutions originating from different countries were investigated. It also included leading distributors of third-party products.

² FINMA Distribution Report 2010, section 8.2

³ Pure derivative products that are not combined with other financial products (e.g. options, futures, warrants, swaps etc.) are by definition not classed as structured products and were thus not included in this investigation. Customised “structured products” tailor-made for individual clients and those intended solely for qualified investors were also excluded, as were prospectuses in accordance with the EU Prospectus Directive.

⁴ Three institutions issued or distributed fewer than ten different structured products in the investigation period, as a result of which the random sample was smaller.

A total of 98 simplified prospectuses from these institutions, together with further documents used at the point of sale such as fact sheets, product flashes and flyers, were checked. The random samples included only documents relating to products issued and distributed between 1 January and 31 May 2011.

4 Regulatory requirements

4.1 Collective Investment Schemes Act and Ordinance

The public distribution of a structured product on the primary market is in principle open to everyone, including market participants not supervised by FINMA. On the secondary market, however, the commercial distribution or trading of structured products is deemed to be securities trading within the meaning of the Stock Exchange Act and is thus subject to FINMA supervision⁵.

If a bank or other provider wishes to issue a structured product, it must in every case produce a simplified prospectus, which must comply with the following requirements in accordance with the CISA⁶:

- It must describe, in accordance with a standard format, the key characteristics of the structured product (key data), its profit and loss prospects, together with the significant risks for investors.
- It must be easily understood by the average investor.
- It must make reference to the fact that the structured product is neither a collective investment scheme, nor does it require authorisation by FINMA (labelling).

Unlike a bond prospectus or a simplified prospectus for a fund, the prospectus for a structured product must be made available to investors only at the time the product is issued or, in subsequent trading on the secondary market, a product agreement is signed⁷ and not when the structured product is first offered publicly for subscription on the primary market. In addition, the requirement to produce a simplified prospectus does not apply where the structured product is listed on a Swiss exchange.⁸

According to the CISO, the requirements for the simplified prospectus are to be formalised through a system of self-regulation and approved by FINMA⁹.

⁵ See FINMA Structured products FAQs, questions 1 and 2 (<http://www.finma.ch/e/faq/beaufsichtigte/pages/faq-strukturierte-produkte.aspx>)

⁶ Art. 5 para. 2 CISA

⁷ Art. 5 para. 3 CISA

⁸ Art. 4 para. 4 let. a CISO; the requirement also does not apply where the structured product is not distributed in Switzerland, but is distributed publicly from Switzerland and transparency pursuant to Art. 5 CISA is assured by virtue of foreign regulations.

⁹ Art. 4 para. 3 CISO

4.2 Self-regulation and FINMA requirements

The Swiss Bankers Association finalised the content of the simplified prospectus in August 2007 after a rather long and difficult process of consultation with what was then the Swiss Federal Banking Commission (SFBC). It then published its “Guidelines on informing investors about structured products” (GL-SBA). These guidelines describe above all the information content required in the prospectus.

Besides the GL-SBA, FINMA’s Frequently Asked Questions list (FINMA FAQs) is also very important as far as structured products are concerned. In these FAQs, FINMA answers first and foremost questions regarding the applicability of the Stock Exchange Act and the Collective Investment Schemes Act, but it also sets out requirements for supervised institutions in terms of the prospectus itself as well as the documentation used on the primary market.

The random checks concentrated on the following aspects:

- **Labelling:** According to the FINMA FAQs, a reference to the effect that a structured product is neither a collective investment scheme nor subject to authorisation by FINMA must appear prominently on the first page of the simplified prospectus and be highlighted in bold¹⁰.
- **Structure/ease of understanding:** FINMA stipulates in its FAQs that the prospectus must be structured according to three main categories (product description, prospects for profits and losses and significant risks for the investor)¹¹. As regards ease of understanding, there are no requirements in the GL-SBA above and beyond what is stipulated by law. The guidelines state that the prospectus may be written in English¹².
- **Risks:** According to the GL-SBA, details of the profit and loss prospects, product-specific risks (such as unlimited potential for loss) and issuer risk¹³ must be included. The reader’s attention must also be drawn to the product’s liquidity and tradability. However, details of market risks¹⁴ and currency risks are not required.

5 Findings of the spot checks

FINMA’s spot checks addressed the aspects of labelling, structure and ease of understanding in prospectuses as well as the requirement for details of the profit and loss prospects and significant risks associated with each structured product.

¹⁰ FINMA FAQs, question 18 (<http://www.finma.ch/e/faq/beaufsichtigte/Pages/faq-strukturierte-produkte.aspx>)

¹¹ FINMA FAQs, question 15 (<http://www.finma.ch/e/faq/beaufsichtigte/Pages/faq-strukturierte-produkte.aspx>)

¹² GL-SBA, section 8.2

¹³ The issuer risk describes the danger that the issuer of a financial product might suffer a credit rating downgrade or become insolvent during the product’s term.

¹⁴ Market risk (also called systematic risk) describes the danger of losses on the value of a broadly diversified investment portfolio.

The issuers and distributors questioned can be divided into three categories on the basis of their activities: “pure issuers” (four institutions), “pure distributors” (two institutions) and “issuer/distributors” (five institutions).

5.1 Documents used at the point of sale

The pure issuers distribute their products to other regulated financial institutions and also offer “indicative” simplified prospectuses¹⁵ for the period prior to issue, regardless of whether or not a particular product is eventually listed¹⁶. These institutions are not in a position to say how often their simplified prospectuses are used at the point of sale.

The pure distributors have the structured products they distribute listed and refer to the fact that this exempts them from the requirement to offer simplified prospectuses. They produce their own product documentation for the point of sale (fact sheets, flyers, product flashes etc.), and this is used for both the primary and secondary markets. In addition, their clients can request a copy of the simplified prospectus originally provided by the issuer. These institutions cannot state precisely how often the simplified prospectuses are used at the point of sale. However, it must be assumed that their use in client consultations is the exception rather than the rule.

Two issuers and distributors provide their clients with both indicative and final simplified prospectuses, regardless of whether or not the products concerned are to be listed. Both institutions use special product documentation rather than the prospectus to explain their products to clients at the point of sale. Clients are only occasionally given a simplified prospectus (indicative or final) at the point of sale. Clients of one institution always receive a printed copy of the simplified prospectus together with their purchase advice. Neither institution is able to estimate how often simplified prospectuses are actually handed out at the point of sale.

Only three institutions in the issuer/distributor category systematically use simplified prospectuses at the point of sale (for the primary and secondary markets). For the period prior to issue (primary market), clients of these institutions are offered indicative prospectuses. One bank estimates that it supplies approximately 90% of people who buy structured products with a simplified prospectus, while another reckons that the percentage is in the high double-digit range. The third institution stresses that the simplified prospectus is used in every consultation at the point of sale.

Main finding: The simplified prospectus tends to play only a secondary role in the advisory process. Most distributors use their own sales documentation (fact sheets, flyers, product flashes etc.) at the point of sale instead.

¹⁵ These differ from a standard simplified prospectus only in that certain parameters (e.g. market price at the time of issue) are not yet known for certain.

¹⁶ At the time a product is launched, it is often unclear whether or not it will ever be offered publicly. The simplified prospectus contains only indicative pricing details during the subscription period (primary market).

5.2 Labelling

All of the simplified prospectuses checked contained a reference to the fact that the product is not a collective investment scheme. With one exception, each provider had some prospectuses with insufficient labelling. In some cases, the reference was not on the first page, not highlighted, or both.

Some of the documents for use at the point of sale that were checked (fact sheets and product flyers, i.e. not simplified prospectuses) provided by three distributors featured labelling that complied with the requirements only in part, and some did not comply at all¹⁷. Documentation provided by two pure issuers was especially unsatisfactory as it systematically included insufficient labelling.

Main finding: In most cases, the labelling requirement is being met correctly, i.e. on the first page of the prospectus and highlighted in bold. However, FINMA identified deficiencies in about a fifth of the simplified prospectuses checked.

5.3 Structuring according to three main categories

The requirement for simplified prospectuses to be structured according to three main categories was only met correctly by five institutions.

One institution did not use the prescribed terminology, and the category “prospects for profits and losses” was completely absent. Not one of the simplified prospectuses provided by five other banks complied with the structure requirements.

Main finding: The structuring of the prospectus according to three main categories is not being implemented sufficiently. Only about half of the prospectuses checked complied with FINMA’s requirements.

5.4 Ease of understanding

The GL-SBA (and the FINMA FAQs) do not elaborate any further on the legal requirement for the simplified prospectus to be easily understood by the average investor. The assessment made here and the resulting conclusions are based on the criteria of wording (conciseness), language, layout/structure and length.

Prospectuses in English are permissible according to the GL-SBA. FINMA agrees with this. As such, it is not suggested anywhere that a prospectus written in English fails to meet the requirement for ease of understanding. However, FINMA’s investigation drew the opposite conclusion.

Results of spot checks for institutions acting as both issuer and distributor

¹⁷ See FINMA FAQs, question 14 (<http://www.finma.ch/e/faq/beaufsichtigte/Pages/faq-strukturierte-produkte.aspx>)

Only two institutions provide their clients with investor-friendly simplified prospectuses in German. These are four to five pages long. Their layout is clear, and they are easy to understand. Only one bank's simplified prospectuses describe specific product-related scenarios, which are very helpful for quickly gaining an understanding of how a product works.

The simplified prospectuses provided by three institutions are only partly comprehensible to the average investor. Especially with more complex products, the reader can quickly become confused due to either a lack of structuring according to the three main categories or the use of English – and highly technical English at that – as well as a lack of explanatory charts and scenarios. One bank's prospectuses are four pages long, another bank's up to 14 pages. In the latter case, the investor is repeatedly confronted with complex conversion factors. Both institutions are clearly aware that their prospectuses are not easy to understand and produce separate sales documentation that, while concisely worded and very easy to understand, does not meet all the supervisory law requirements pertaining to a prospectus. Another institution uses prospectuses available in German and English that, while short at four pages, are not easy to understand. On the one hand, these prospectuses are not clearly structured. On the other, they do not give sufficient details of the profit and loss prospects.

Findings of spot checks for pure distributors

Two pure distributors use their own documentation together with issuers' prospectuses to explain products to their clients. The proprietary documentation is easy to understand and well structured, but it does not explain all the risks. Reference to liquidity and market risks and details of the place of jurisdiction are missing.

Findings of spot checks for pure issuers

The simplified prospectuses provided by three pure issuers cannot be easily understood by the average investor and are between nine and 12 pages long, or up to 14 pages long including appendices. While at least one issuer complies with the structuring according to the three main categories, the documentation provided by all three is not clearly structured. The prospectuses for more complex products seem very hard to understand. There is a total lack of payoff charts and product-related scenarios. In addition, these issuers' prospectuses are only available in English. One issuer does not give a separate description of the profit and loss prospects in individual prospectuses and, in the majority of the prospectuses checked, only mentions the significant risks in the small print of an appendix. Another only mentions in the small print on page 7 that there is an issuer risk and that the structured product is not a collective investment scheme. The three issuers, either generally or at the distributor's request, produce concise and relatively investor-friendly brief overviews, but these do not meet the supervisory law requirements.

Main finding: Most of the simplified prospectuses that were checked are not easy to understand. They are often too long¹⁸, too technical in their wording, not structured in a uniform manner and lacking in explanatory scenarios and charts. In particular, prospectuses published in English are very difficult for the average investor whose first language is not English to understand. In contrast, the sales documents used at the point of sale tend to be clear and easy to understand, but they do not meet the supervisory law requirements pertaining to the simplified prospectus in full.

Only two institutions provided prospectuses that were genuinely easy to understand. These two examples prove that it is possible for a simplified prospectus to fulfil the supervisory law requirements while at the same time being easily understood by investors.

5.5 Profit and loss prospects

Investors must not be given a distorted picture of the opportunities and risks. The simplified prospectus must inform them in a transparent manner about the potential profit and loss scenarios.

All of the simplified prospectuses checked contained information on the product-specific profit and loss prospects. Only one institution fails to describe the product-specific risks under a separate heading, making it much harder for investors to build up a picture of the product's risk profile. In individual cases, there is no mention of the possibility of a total loss or market price risks attached to underlying assets under the main category "prospects for profits and losses", which does not seem expedient.

Main finding: Providers describe the profit and loss prospects of each product in full.

5.6 Significant risks

In the vast majority of the simplified prospectuses checked, issuers explain the significant risks – credit, issuer, market, liquidity and currency risks – in detail.

Besides a few relatively insignificant or one-off deficiencies, the way risks are presented and/or weighted by two issuers is unacceptable. In the majority of the prospectuses provided by one pure issuer, the risks are only mentioned in an appendix. Another fails to portray the individual risks, apart from the issuer risk, in a clearly structured manner. They are mentioned in hard-to-read small print in English towards the end of the prospectus.

Main finding: By and large, prospectuses list and explain the significant risks in full. There are some deficiencies in terms of form rather than content.

¹⁸ The average prospectus length was found to be six pages. Some were 14 pages long, the shortest just three pages.

5.7 Comparison of individual institutions

The table below gives a summary overview of the weaknesses that were identified among the institutions questioned:

		Product transparency					Risk transparency				
		Labelling	Structure	Ease of understanding	Taxes	Jurisdiction	Profit/loss prospects	Issuer risk	Market risk	Currency risk	Liquidity risk
Pure issuers	1	Yellow	Red	Yellow	Green	Green	Green	Red	Green	Green	
	2	Green	Green	Green	Green	Green	Green	Green	Green	Green	
	3	Red	Yellow	Red	Red	Green	Green	Yellow	Yellow	Yellow	
	4	Red	Green	Red	Green	Green	Green	Yellow	Green	Green	
Pure distributors	1	Green	Yellow	Yellow	Green	Green	Green	Yellow	Green	Green	
	2	Green	Red	Yellow	Green	Green	Green	Green	Green	Green	
Issuer/distributors	1	Green	Red	Red	Green	Green	Green	Green	Green	Green	
	2	Yellow	Red	Yellow	Green	Green	Yellow	Green	Green	Green	
	3	Green	Green	Yellow	Green	Green	Green	Green	Green	Green	
	4	Green	Green	Green	Green	Green	Green	Green	Green	Green	
	5	Green	Green	Green	Green	Green	Green	Green	Green	Green	

Green: complies with requirements
Yellow: complies only partially with requirements
Red: does not comply with requirements in most checked cases

Only two of the 11 institutions investigated are in full compliance with all the prospectus requirements. The majority show deficiencies in the structure of their prospectuses and the ease with which they can be understood. In addition, the rules on labelling are not being complied with to a satisfactory degree. Compliance with the majority of the other requirements that were investigated has to date been good to very good. At the level of the individual institutions, two pure issuers in particular stand out with a number of deficiencies in terms of both form and content. These are being discussed with the institutions concerned, and they will be required to take corrective action.

FINMA's investigation revealed no evidence of conduct that may potentially be sanctionable due to violations of the prospectus requirement under Article 148 or 149 CISA. On the basis of the findings so far, there is no need to initiate proceedings under supervisory law against any individual provider. However, if the deficiencies that were identified are not appropriately rectified, enforcement measures will have to be taken.

5.8 Principal weaknesses

As the table above shows, the greatest weaknesses concern the structure of prospectuses and the ease with which they can be understood, both of which are key legal requirements.

FINMA's investigations have revealed that the standardised format required for simplified prospectuses does not exist in practice across the various issuers. Instead, they take extremely different approaches as regards the presentation of their prospectuses. With the exception of the product description (key data), investors have very little scope for comparing structured products on the basis of the simplified prospectus. In addition, compliance with FINMA's minimum requirement for the prospectus to be divided into the three main categories is insufficient.

The legal requirement that the prospectus be easily understood is only being met in exceptional cases. The vast majority of prospectuses are not easy for the average investor to understand, and those written in English are in fact hard for the average investor whose first language is not English to understand.

FINMA's checks showed that the general tendency is for all of the content listed in and required by the GL-SBA to be included in the prospectus, albeit not in a form that is clearly structured and easily understood.

There are currently no supervisory law requirements governing the disclosure of all fee components for structured products. The investigation has made it clear that providers do not disclose their fees voluntarily. However, knowing the one-off and recurring costs a product entails can significantly influence an investor's decision as to whether or not to buy it. It also makes it easier to compare products offered by different providers.

6 Conclusions from FINMA's point of view

The spot checks revealed deficiencies in the documentation provided to clients when they buy structured products. As a rule, these are not the result of any violation of the applicable prospectus requirements for structured products. Rather, they can be blamed on the legislator's failure to stipulate comprehensive documentation requirements and on the fact that the legal requirements are only partially implemented at the level of self-regulation.

Information on structured products for clients can be improved by the individual product providers. However, based on the findings of the spot checks and the applicable requirements according to the GL-SBA on informing investors about structured products, there are no grounds to expect that the industry will take action to improve client protection. At the same time, the protection of those buying structured products can be improved by revising the regulatory requirements contained in the CISA and CISO. As FINMA noted in its comments on the partial revision of the CISA, published on 7 October 2011, it supports this course of action. In particular, it calls for providers of structured products to be subject to suitable rules of conduct, as is already the case for all holders of a licence under the CISA.

Furthermore, the regulatory requirements concerning product documentation must be worded such that they reflect the legislator's original aims, namely that the documentation should suitably inform clients about a product's characteristics and risks. The requirements must ensure that the documentation is written in easily understandable language and allows different products to be compared. In addition, transparency is needed with regard to the direct and indirect costs that investors incur when buying and holding structured products. Last but not least, assurance is needed that clients will be provided with binding product documentation in good time, i.e. when they subscribe.