

**Thematic Review on Suitability Requirements  
with respect to the Distribution of  
Complex Financial Products**

**Final Report**



**OICU-IOSCO**

**THE BOARD  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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## Contents

<b>1.</b>	<b>EXECUTIVE SUMMARY .....</b>	<b>1</b>
<b>2.</b>	<b>BACKGROUND .....</b>	<b>2</b>
2.1.	IOSCO’s Suitability Requirements .....	2
2.2.	Reasons for the Review.....	2
<b>3.</b>	<b>METHODOLOGY .....</b>	<b>3</b>
3.1.	Nature of the Review and Objectives .....	3
3.2.	Review Process .....	3
3.3.	Review Team .....	5
3.4.	Participating Jurisdictions .....	5
<b>4.</b>	<b>FINDINGS AND OBSERVATIONS .....</b>	<b>5</b>
4.1.	Overview of Consistency by Jurisdiction .....	5
4.2.	Non-Principle-Related Observations .....	7
4.2.1.	<i>Definition of Intermediary</i> .....	7
4.2.2.	<i>The Notion of ‘Complex’ Products and Market Context</i> .....	8
4.2.3.	<i>Regulatory Structure and Rulemaking Approaches</i> .....	9
4.2.4.	<i>Regulatory Reform</i> .....	10
4.2.4.1.	<i>MiFID II</i> .....	10
4.2.4.2.	<i>FinTech</i> .....	11
4.3.	Principle-by-Principle Analysis .....	13
4.3.1.	<i>Principle 1 – Classification of Customers</i> .....	13
4.3.2.	<i>Principle 2 – General Duties Irrespective of Customer Classification</i> .....	15
4.3.3.	<i>Principle 3 – Disclosure Requirements</i> .....	16
4.3.4.	<i>Principle 4 – Protection of Customers for Non-Advisory Services</i> .....	19
4.3.5.	<i>Principle 5 – Suitability Protections for Advisory Services</i> .....	21
4.3.6.	<i>Principle 6 – Sufficient Information/Reasonable Basis</i> .....	24
4.3.7.	<i>Principle 7 – Compliance Function</i> .....	26
4.3.8.	<i>Principle 8 – Incentives</i> .....	27
4.3.9.	<i>Principle 9 – Enforcement</i> .....	29
<b>5.</b>	<b>RECOMMENDATIONS .....</b>	<b>30</b>
	<b>ANNEX A – LIST OF PARTICIPATING JURISDICTIONS .....</b>	<b>33</b>
	<b>ANNEX B – ASSESSMENT METHODOLOGY AND QUESTIONNAIRE .....</b>	<b>34</b>

## 1. EXECUTIVE SUMMARY

This report sets out the findings of the Thematic Review (**Review**) by the International Organization of Securities Commissions (**IOSCO**) of the implementation by IOSCO member jurisdictions of the nine Principles set out in IOSCO's *Suitability Requirements with Respect to the Distribution of Complex Financial Products* report (the **2013 Report** or the **Principles**).<sup>1</sup>

This consistency review considered how IOSCO members have implemented suitability standards aimed at preventing the mis-selling of complex financial products. A Review Team representing six IOSCO member jurisdictions and the IOSCO Secretariat (**Review Team**) developed and applied a standardized review process (see Section 3) to assess the consistency of implemented measures against each of the nine Principles.

The assessment is based on a review of the legislative, regulatory and policy measures reported as being in place by participating jurisdictions (based generally on information as of end-February 2018). Twenty-nine IOSCO members from 28 jurisdictions (**Participating Jurisdictions**) participated in this Review (see Annex A). The Review Team received 27 responses to the Questionnaire by May 2018.<sup>2</sup> The Review Team then considered whether and when to challenge the self-assessments and conducted follow-up discussions with Participating Jurisdictions until 31 August 2018. Participating Jurisdictions were given an opportunity to confirm the way their responses have been reflected in this report.<sup>3</sup>

Key findings (see Section 4 which includes Table 2 on Participating Jurisdictions' Consistency of Implementation) and observations from this Review include:

- The majority of Participating Jurisdictions have implemented suitability requirements generally in line with the Principles;
- Participating Jurisdictions generally had product complexity-neutral suitability regimes (i.e., did not have bespoke requirements specifically for complex products);
- What constitutes a complex financial product differs amongst jurisdictions;
- Most jurisdictions have standards for dealing with customers fairly and for dealing with conflicts of interest;
- Many Participating Jurisdictions do not require intermediaries to consider product riskiness or complexity in connection with classifying some customers;

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<sup>1</sup> *Suitability Requirements with Respect to the Distribution of Complex Financial Products*, IOSCO, January 2013, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf>.

<sup>2</sup> Two pairs of members (Ontario and Quebec, and the US Securities and Exchange Commission and the Financial Industry Regulatory Authority) submitted joint responses, thus the Review Team received 27 responses from 28 jurisdictions.

<sup>3</sup> Participating jurisdiction reviewed the draft report and provided comments to it. This fact-checking period concluded in May 2019.

- The robustness of suitability regimes appears to correlate to levels of market development and participation; and
- FinTech development in respect of digital advisors and online platforms has created new suitability-related challenges.

Section 4.3 sets out a detailed discussion of implementation on a Principle-by-Principle basis with examples of different jurisdictions' implementation approaches. The inclusion of examples should not be interpreted as a normative assessment of the desirability of such approaches.

## **2. BACKGROUND**

### **2.1. IOSCO's Suitability Requirements**

In January 2013, IOSCO published *Suitability Requirements with Respect to the Distribution of Complex Financial Products*. The 2013 Report considers customer protections, focusing on intermediaries' responsibilities to assess the suitability of their recommendations and discretionary decisions and other customer protections relevant to the distribution of complex financial products, including disclosure requirements.

The 2013 Report sets out nine Principles,<sup>4</sup> focused on the application of suitability and related requirements to intermediary services including selling, advising, recommending and managing discretionary accounts/portfolios. The Principles also address intermediaries' incentives, conduct and responsibilities in relation to both advisory and non-advisory services as well as the regulator's role in supervision and enforcement.

The Principles were developed in response to the global financial crisis, which made clear that the growing complexity of financial products might make the associated investment risks less apparent to customers and questioned intermediaries' conduct and responsibility for assessing suitability of structured products.

### **2.2. Reasons for the Review**

The purpose of the Review was to understand how IOSCO member jurisdictions have implemented suitability standards aimed at preventing mis-selling of complex financial products. This work focuses on business conduct and the risks posed by complex financial products and is consistent with IOSCO's core objective of investor protection.<sup>5</sup> Mis-selling undermines investors' trust in market participants and the financial markets, which also impacts IOSCO's other objectives of ensuring fair and efficient markets and preventing systemic risk.

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<sup>4</sup> The Principles cover the following areas: Classification of customers; General duties irrespective of customer classification; Disclosure requirements; Protection of customers for non-advisory services; Suitability protections for advisory services (including portfolio management); Compliance function and internal suitability policies and procedures; Incentives; and Enforcement.

<sup>5</sup> IOSCO has three core objectives, the other two are ensuring that markets are fair, efficient and transparent; and reducing systemic risk.

This Review considers different regulatory models and intermediary distribution channels, including some ways Fintech has impacted the suitability space subsequent to the 2013 Report.

The Review followed the focus of the Principles, which is the application of suitability and related disclosure requirements to intermediaries (as defined in the IOSCO Principles and Methodology)<sup>6</sup> in connection with their sale of complex financial products to retail and non-retail customers (as defined in individual jurisdictions).

For the purposes of the Review, “complex financial products” refer to financial products, whose terms, features and risks are not reasonably likely to be understood by a retail customer (as that term is defined in individual jurisdictions) because of their complex structure (as opposed to more traditional or plain vanilla investment instruments), and which may be difficult to value (i.e., their valuations require specific skills and/or systems, particularly when there is a very limited or no secondary market).

Thus, all IOSCO members that have complex financial products were invited to participate in the Review. Twenty-nine IOSCO members from 28 jurisdictions participated in the Review. While each Participating Jurisdiction reported having products they regard as complex, the marketplace for complex products, in terms of the range of available products and investor participation, appears to be more significant in some jurisdictions than in others. Participating Jurisdictions included both developed and growth and emerging market jurisdictions.

### **3. METHODOLOGY**

#### **3.1. Nature of the Review and Objectives**

On 20 December 2017, the IOSCO Board approved the Project Specifications for this Review. The main objectives of the Review are to assess the consistency of implementation of the nine Principles by 28 Participating Jurisdictions and to describe the legislative, regulatory and policy measures that have been taken.

The Review Team developed an Assessment Methodology and Questionnaire (**Questionnaire**) – see Annex B – as well as a Rating Scale to reflect the nature and scope of the Principles and their related ‘Means of Implementation’ (**MoI**), which provide guidance and further elaboration for jurisdictions to consider when implementing each Principle.

#### **3.2. Review Process**

The Review was a desk-based exercise. The Assessment Methodology and Questionnaire was circulated on 2 March 2018, with responses due on 13 April 2018. Late responses were accepted until 9 May 2018. Various jurisdictions were in the process of reform and, while developments up until 31 August 2018 (**Assessment Date**) were factored into the ratings, the Review Team was unable to consider later developments.

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<sup>6</sup> See Section 4.2.1 Definition of Intermediary.

The Questionnaire asked Participating Jurisdictions to describe how their regulatory systems address the issues covered by the nine Principles with reference to relevant legislation, regulation or policy measures (e.g. rules or guidance) in effect at 28 February 2018. It also asked for a self-assessment against the following Rating Scale in Table 1:

*Table 1 – Rating Scale*

<b>Fully Consistent</b>	The jurisdiction’s regulatory framework is <b>fully consistent</b> with the Principle. The assessment has identified <b>no gaps or shortcomings</b> , or only a few gaps/shortcomings that have <b>no material impact</b> on the intended outcomes of the Principle.
<b>Broadly Consistent</b>	The jurisdiction’s regulatory framework is <b>broadly consistent</b> with the Principle. The assessment has identified gaps/shortcomings that have only a <b>minor impact</b> on the intended outcomes of the Principle.
<b>Partly Consistent</b>	The jurisdiction’s regulatory framework is <b>partly consistent</b> with the Principle. The assessment has identified gaps/shortcomings that have a <b>significant impact</b> on the intended outcomes of the Principle.
<b>Not Consistent</b>	The jurisdiction’s regulatory framework is <b>not consistent</b> with the Principle. The assessment has identified that the jurisdiction’s regulatory framework does not achieve the intended outcomes of the Principle.
<b>Not Applicable</b>	No implementation measures needed given the nature of the securities market and/or relevant structural, legal and institutional considerations. This status corresponds to the case where there is <b>no market or activity</b> in the jurisdiction that falls within the scope of the Principle.

To analyze consistency in implementation, the Review Team considered the 2013 Report to identify the objectives and critical elements of each Principle, then developed assessment criteria for each benchmark rating. These criteria are explained in Section 4.3 Principle-by-Principle Analysis.

On whether and when to challenge self-assessments, the Review Team agreed that it should limit challenging the ratings in jurisdictions’ self-assessments to the following situations:

- (i) Where the Rating Scale had been misapplied and/or the basis to support the implementation was not clear;
- (ii) Where purported implementation clearly was not related to the Principle(s);
- (iii) Where the scope of the implementation measures did not cover the full scope intended by the Principle(s).

The Review Team based its assessments on information provided by the Participating Jurisdictions, including copies of published and/or in-force legislation, regulations or policies. The Review Team reviewed the information submitted by Participating Jurisdictions for completeness and, where necessary, contacted Participating Jurisdictions to clarify and/or

verify statements in their responses. The Review Team also reviewed the self-assessments to identify where Participating Jurisdictions may have interpreted the Principles or Questionnaire differently. However, the Review Team did not seek to verify independently all statements provided by Participating Jurisdictions in their submissions for this Review.

### **3.3. Review Team**

The Review Team included staff from the following regulatory authorities: Mark McGinness and Dean Miller (Dubai Financial Services Authority), Jennifer D’Hoir and Charlotte Gardes (France, Autorité des marchés financiers), Daniela Rothe (Germany, Federal Financial Supervisory Authority), Grace Chan and Elizabeth Wong (Hong Kong, Securities and Futures Commission), Christina Aw (Singapore, Monetary Authority of Singapore), Peter Maas (United Kingdom, Financial Conduct Authority) and Raluca Tircoci-Craciun, Anna Zhang and Josafat De Luna Martinez (IOSCO General Secretariat).

The Review Team was led by Jennifer D’Hoir and Mark McGinness.

### **3.4. Participating Jurisdictions**

All IOSCO Board and Assessment Committee members that have complex financial products, as defined in the 2013 Report, were expected to participate in the Review. All other IOSCO member jurisdictions that have complex financial products were welcomed to participate.

Twenty-nine IOSCO members from 28 jurisdictions participated in this Review. The List of Participating Jurisdictions is set out at Annex A.

## **4. FINDINGS AND OBSERVATIONS**

Section 4.1 provides an overview of implementation status in Participating Jurisdictions. This section includes Table 2, which sets out the Review Team’s ratings for each jurisdiction in respect of their consistency with each of the nine Principles.

Section 4.2 sets out high level observations of certain themes and issues affecting implementation, while Section 4.3 follows with a Principle-by-Principle analysis of the regimes in the Participating Jurisdictions.

### **4.1. Overview of Consistency by Jurisdiction**

The Review determined the majority of Participating Jurisdictions to have implemented suitability requirements for complex products in manners generally consistent with the Principles. While only five jurisdictions earned ratings of ‘Fully Consistent’ across all nine of the Principles, the Review Team rated the majority of the remaining jurisdictions as Fully or Broadly Consistent across most of the Principles. The Review Team observed that, in some cases, jurisdictions rated Partly Consistent or Not Consistent for some Principles had reforms in progress, which may improve these ratings once implemented.

**Table 2** sets out the Review Team’s assessment of each Participating Jurisdiction’s consistency with each of the nine Principles.

**Table 2 – Participating Jurisdictions’ Consistency of Implementation**

	Principle 1 Classification	Principle 2 General Duties	Principle 3 Disclosure	Principle 4 Non-advisory Services	Principle 5 Suitability Requirements	Principle 6 Intermediary Understanding	Principle 7 Compliance	Principle 8 Incentive Policies	Principle 9 Supervision/ Enforcement
Bahamas	Yellow	Yellow	Yellow	Red	Red	Red	Yellow	Red	Red
Belgium	Yellow	Green	Green	Green	Green	Green	Green	Green	Green
Brazil	Yellow	Green	Yellow	Green	Green	Yellow	Green	Red	Yellow
Ontario / Quebec (Canada) <sup>7</sup>	Green	Green	Green	Green	Green	Green	Green	Yellow	Green
China	Green	Green	Green	Green	Green	Green	Green	Green	Green
DIFC <sup>8</sup>	Yellow	Green	Red	Red	Yellow	Yellow	Yellow	Green	Yellow
France	Yellow	Green	Green	Green	Green	Green	Green	Green	Green
Germany	Yellow	Green	Green	Green	Green	Green	Green	Green	Green
Hong Kong	Green	Green	Green	Green	Green	Green	Green	Green	Green
Indonesia	Yellow	Yellow	Green	Green	Yellow	Yellow	Green	Yellow	Yellow
Ireland	Yellow	Green	Green	Green	Green	Green	Green	Green	Green
Italy	Yellow	Green	Green	Green	Green	Green	Green	Green	Green
Japan	Green	Green	Green	Green	Green	Green	Green	Green	Green
Korea, Republic of	Yellow	Yellow	Yellow	Green	Yellow	Yellow	Yellow	Yellow	Yellow
Morocco	Red	Red	Red	Red	Red	Red	Red	Red	Red
Papua New Guinea	Red	Red	Red	Red	Red	Red	Red	Red	Red
Poland	Yellow	Green	Green	Green	Green	Green	Green	Green	Green
Portugal	Yellow	Green	Green	Green	Green	Green	Green	Green	Green
Russia	Yellow	Green	Green	Yellow	Yellow	Yellow	Yellow	Red	Yellow
Singapore	Green	Green	Green	Green	Green	Green	Green	Green	Green
South Africa	Red	Green	Yellow	Yellow	Yellow	Yellow	Green	Green	Yellow
Spain	Yellow	Green	Green	Green	Green	Green	Green	Green	Green
Sweden	Yellow	Green	Green	Green	Green	Green	Green	Green	Green
Switzerland	Yellow	Green	Yellow	Yellow	Yellow	Yellow	Yellow	Yellow	Green
Turkey	Yellow	Green	Yellow	Green	Yellow	Yellow	Yellow	Yellow	Yellow
United Kingdom	Yellow	Green	Green	Green	Green	Green	Green	Green	Green
United States <sup>9</sup>	Green	Green	Green	Green	Green	Green	Green	Yellow	Green

<sup>7</sup> The Ontario Securities Commission and Québec Autorité des marchés financiers, which are each IOSCO members, submitted a joint response. While rated jointly, references in this report to numbers of jurisdictions consider them separately.

<sup>8</sup> The Dubai International Financial Centre (DIFC) is a Federal Financial Free Zone administered by the Government of Dubai and established in accordance with United Arab Emirates Federal Law. The financial entities in the DIFC are regulated and supervised by the Dubai Financial Services Authority (DFSA), which has entered into bilateral and multilateral cooperation agreements.

<sup>9</sup> The response for the United States was submitted jointly by staff of the US Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA is an Affiliate Member of IOSCO). It should be noted that, for the purposes of the 2013 Report, the term intermediary in the U.S. securities sector refers to registered swap dealers and broker-dealers, not investment advisers. In this Review, the SEC staff addressed those aspects related to broker-dealers. In the US, broker-dealers are subject to comprehensive regulation under the federal securities laws and self-regulatory organization (SRO) rules.

## 4.2. Non-Principle-Related Observations

The Review Team observed certain issues and themes among the Participating Jurisdictions, which do not relate specifically to any one Principle, but are nevertheless relevant and help explain nuances to the suitability approaches taken by some jurisdictions. These relate to definitions of intermediaries; treatment of complex products; regulatory structure; and regulatory reform.

### 4.2.1. Definition of Intermediary

The Glossary of the 2013 Report defines an *intermediary* to be: “a firm in the business of managing individual portfolios, providing investment advice, executing orders on behalf of third parties, dealing in or distributing securities (including carrying derivatives positions).<sup>10</sup> In jurisdictions where banks are permitted to provide investment services, this term includes banks to the extent they are providing such services.”<sup>11</sup> This definition is consistent with the definition of “market intermediaries” that is provided in the IOSCO Methodology (May 2017),<sup>12</sup> which indicates that this term “generally include[s] those who are in the business of managing individual portfolios, executing orders and dealing in, or distributing, securities”. According to the methodology, a jurisdiction may also choose to regulate as a market intermediary an entity that simply provides advice regarding the value of securities or the advisability of investing in, purchasing or selling securities.<sup>13</sup>

Generally, all but one of the Participating Jurisdictions have defined the types of institutions or the nature of the services to which their regulatory systems apply.<sup>14</sup> In so doing, many, but not all, of them have also defined terms such as ‘intermediary,’ ‘investment firm,’ or similar. The Review Team observed the definitions used by Participating Jurisdictions to vary, but generally to align with the 2013 Report, though some jurisdictions, such as Switzerland, have adopted broader definitions, which may scope in certain client types or products. For example, in the Bahamas, a person conducting ‘securities business’ must register with the regulator,<sup>15</sup> while in

<sup>10</sup> The definition includes firms such as product providers who are also intermediaries, and which directly distribute complex financial products they produce. The term does not include issuers who are not intermediaries.

<sup>11</sup> See Chapter 2 (“Glossary”) in Suitability Requirements with Respect to the Distribution of Complex Financial Products, IOSCO, January 2013, 5–7 available at:

<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf>.

<sup>12</sup> IOSCO Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation, IOSCO, May 2017, available at:

<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD562.pdf>, page 192.

<sup>13</sup> See 2013 Report, footnote 4. However, for the purposes of the 2013 Report, the term intermediary in the U.S. securities sector refers to registered swap dealers and broker-dealers, not investment advisers.

<sup>14</sup> The response from Papua New Guinea did not elucidate an applicable definition of intermediaries.

<sup>15</sup> In the Bahamas, ‘securities business’ has been defined to include dealing in securities, arranging deals in securities, managing securities, and advising on securities.

Hong Kong, *intermediary* refers to an entity licensed or registered to carry on ‘regulated activities,’ which includes activities beyond those covered by the 2013 Report. The Moroccan definition of intermediary includes broker-dealers, banks and insurance companies and, more broadly, companies whose business is to provide financial counselling or investment services.<sup>16</sup>

The Markets in Financial Instruments Directive II (**MiFID II**) does not define *intermediary* as a term, but expressly applies to firms that provide certain enumerated investment services or perform certain investment activities. In Ireland, which is a MiFID II jurisdiction, the Central Bank has exercised its discretion to regulate certain ‘retail intermediaries’ outside of its MiFID-based framework. In this context, ‘retail intermediaries’ are authorized only to deal in certain investment products, which include collective investment schemes and certain transferable securities.<sup>17</sup> For purposes of this Review, the term intermediary in the US securities sector refers to broker-dealers, but not to investment advisers.

In light of the discretion afforded by the 2013 Report to jurisdictions to tailor this definition, as appropriate, to their domestic market and regulatory context, the Review Team did not factor the consistency of definitions into the assessed ratings. For assessment purposes, a broad definition would not impact the assessment of a jurisdiction as long as the relevant requirements apply at least to the types of entities covered by the 2013 Report and it regulates compliance with such requirements, accordingly.

#### **4.2.2. The Notion of ‘Complex’ Products and Market Context**

The majority of Participating Jurisdictions (19 out of 28) require intermediaries to distinguish between complex and non-complex products.<sup>18</sup> Generally, these jurisdictions support this distinction by:

- Defining the products or product attributes that are complex;
- Defining specific products as non-complex, while generally regarding all others as complex; and/or
- Providing guidance on product complexity in lieu of codified standards.

In most cases, the Review Team determined these standards or criteria to be materially similar to the definition of ‘Complex financial products’ contained in the 2013 Report.<sup>19</sup> EU

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<sup>16</sup> Notwithstanding this broad definition, the questionnaire submitted by the Moroccan Authority of Capital Markets focused primarily on the activities of financial counsellors, which are the sub-set of intermediaries expected to be covered by relevant regulatory reforms currently underway.

<sup>17</sup> In its response, the Central Bank of Ireland refers to discretion afforded by Article 3 of MiFID II, which has been exercised by the Minister of Finance, and which allows Member States to regulate certain firms outside of the MiFID II framework, subject to certain conditions.

<sup>18</sup> Belgium, Brazil, China, France, Germany, Hong Kong, Ireland, Italy, Japan, Ontario and Quebec, Poland, Portugal, Russia, Singapore, South Africa, Spain, Sweden, and the United Kingdom.

<sup>19</sup> See Chapter 2 (“Glossary”) in Suitability Requirements with Respect to the Distribution of Complex Financial Products, IOSCO, January 2013, 5–7 available at:

jurisdictions tended to converge around a common MiFID II-based definition, while many also cited to a 2014 opinion by the European Securities and Markets Authority (ESMA), which provides further guidance and criteria for classifying complex products.<sup>20</sup> While otherwise materially similar, the ESMA opinion specifically mentions certain product types in addition to those in the 2013 Report, including binary options, contracts for difference, and turbos.

The Review Team observed definitions that varied from the 2013 Report most frequently in developing jurisdictions, where such definitions may reflect the current state of market development and investor sophistication. For example, in South Africa, the group of Tier 1 complex products defined by the Financial Sector Conduct Authority (FSCA) includes collective investment schemes and securities, while in Morocco, the Autorité Marocaine du Marché des Capitaux (AMMC) defines complex products to include any debt instrument not linked to the Moroccan Yield Curve; each of these definitions may include products specifically carved out of the definition in the 2013 Report.

Based on this review, definitions of complexity appear to correlate to levels of market development, which, in turn, appear to correlate to robustness of suitability frameworks. The Review Team tried to balance proportionality and consistency while assessing suitability regimes, which may not always be reflected clearly in the ratings. That is, while a developing jurisdiction may have been rated favorably here – such as a ‘Fully Consistent’ or ‘Broadly Consistent’ rating – based on the appropriateness of the suitability framework under prevailing market conditions, the adequacy of that framework may become stressed if the market composition (i.e., customers, products, or both) changes in sophistication or complexity.

#### **4.2.3. Regulatory Structure and Rulemaking Approaches**

Participating Jurisdictions have different legal and regulatory frameworks, which influence how they implement the Principles. Thus, the Review Team observed differences among Participating Jurisdictions in the areas of: legislative or statutory-based requirements versus regulation-based requirements; principles versus rules-based regulation; statutory regulation versus self-regulation (i.e., industry bodies); and differences in supervisory approaches.<sup>21</sup> Notably, while differences between these models affect *how* each jurisdiction implements the Principles, they may not affect *whether* a jurisdiction can implement the Principles effectively. The Review Team assessed each jurisdiction in light of the circumstances prevailing in that jurisdiction and, in so doing, has attempted to avoid a comparative analysis of the different models, themselves, and did not seek to opine on the relative effectiveness of them.

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<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf>.

<sup>20</sup> [https://www.esma.europa.eu/sites/default/files/library/2015/11/ipisc\\_complex\\_products\\_-\\_opinion\\_20140105.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/ipisc_complex_products_-_opinion_20140105.pdf)

<sup>21</sup> The majority of the Participating Jurisdictions are statutory regulators. This group also includes self-regulatory models including, for example, the United States, where broker-dealer intermediaries are subject to US SEC comprehensive regulation under the federal securities laws and self-regulatory organization rules, such as FINRA’s self-regulatory scheme.

#### **4.2.4. Regulatory Reform**

Through the Questionnaire and subsequent discussions with Participating Jurisdictions, the Review Team learned about a variety of legislative and rulemaking developments in respect of suitability. In some cases, such as MiFID II transposition, these had been largely completed before the commencement of this Review and, thus, were able to be considered here. In other cases, some Participating Jurisdictions have reforms in progress, which we could not factor into the ratings, but have been able to acknowledge in different parts of this report. As might be expected, the Review Team observed that reforms in more developed jurisdictions seek to strengthen existing frameworks, while emerging jurisdictions are more likely to be establishing their first suitability regimes.

The Review Team encourages the involvement of developing jurisdictions in these implementation monitoring exercises to ensure that IOSCO's standards are comprehensive, inclusive and support capacity building. At the same time, the Review Team acknowledges the difficulty of rating and comparing jurisdictions with nascent suitability frameworks to those with more mature, developed regimes. In this exercise, Morocco and Papua New Guinea responded that they were in the process of developing, for the first time, regulatory frameworks for suitability regarding complex products.

The Review Team assessed Morocco and Papua New Guinea as “Not Consistent” for each of the Principles. These ratings are based entirely on the fact that, while considerable work toward regulatory reform is underway in these jurisdictions, the legislation or rules related to suitability and/or the relevant supervisory and enforcement programs had not come online by the effective date for the Review. The Review Team acknowledges that these jurisdictions have lesser, though growing, retail participation with fewer complex products than do other Participating Jurisdictions. Consequently, these results should be interpreted constructively. The Review Team commends Morocco and Papua New Guinea for their participation in the Review and encourages them, along with other emerging markets, to use its wider results as benchmarking to inform further development of their regulatory systems.

##### **4.2.4.1. MiFID II**

The recent **MiFID II** framework<sup>22</sup> aims inter alia to strengthen investor protection by introducing new requirements on product governance and independent investment advice, extending existing rules to structured deposits, and enhancing several existing requirements in areas such as the responsibility of management bodies, information and reporting to clients, inducements and staff remuneration, and best execution.

To promote consistency in supervisory approaches and practices under MiFID II and national implementing measures, particularly in relation to investor protection provisions, ESMA has published a series of guidelines, often called “level 3” EU regulation, to which some

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<sup>22</sup> The MiFID II framework applies since 3 January 2018: it consists of a directive (MiFID II - Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments) and a regulation (MiFIR – Regulation 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments).

participating EU-based jurisdictions have referred in their responses to the Questionnaire. These include guidelines addressing:

- MiFID II product governance requirements (in effect since 3 January 2018);<sup>23</sup>
- The assessment of knowledge and competence (in effect since 3 January 2017);<sup>24</sup> and
- Certain aspects of MiFID II suitability requirements (published on 6 November 2018).<sup>25</sup>

ESMA publishes its guidelines on its website once they have been approved by the Board of Supervisors and translated into the official EU languages. This publication triggers a two-month period during which the EU national competent authorities (NCAs) are required to notify ESMA whether or not they comply with the guidelines.

#### ***4.2.4.2.FinTech***

Other than a reference to trading platforms under Principle 4, the 2013 Report and its Principles do not expressly reference FinTech or particular technology developments. Consequently, the Review Team did not ask specifically about FinTech in the Questionnaire. Nevertheless, several responses to the Questionnaire brought up relevant FinTech developments and shed light on the proliferation and impact of FinTech in a variety of ways. As a result, the Review Team believed it appropriate to acknowledge those contributions here. Because the Principles do not address FinTech, the Review Team assessed each jurisdiction's consistency with them in a 'technology-neutral' manner. According to Questionnaire responses, the FinTech developments most relevant to Participating Jurisdictions and suitability involve the emergence of digital or automated investment advisors and the proliferation of self-directed online trading platforms, which may perform like broker-dealers or exchanges.<sup>26</sup>

Digital investment advisors (colloquially, "robo-advisors") use algorithms to develop investment advice based on customers' profiles and often can execute transactions without any human intervention. Frequently, such providers establish these profiles using a short

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<sup>23</sup> *Guidelines in MiFID II product governance requirements*, ESMA, February 2018, available at [https://www.esma.europa.eu/sites/default/files/library/esma35-43-620\\_guidelines\\_on\\_mifid\\_ii\\_product\\_governance\\_requirements\\_0.pdf](https://www.esma.europa.eu/sites/default/files/library/esma35-43-620_guidelines_on_mifid_ii_product_governance_requirements_0.pdf).

<sup>24</sup> *Guidelines for the assessment of knowledge and competence*, ESMA, January 2017, available at [https://www.esma.europa.eu/sites/default/files/library/esma71-1154262120-153\\_guidelines\\_for\\_the\\_assessment\\_of\\_knowledge\\_and\\_competence\\_corrigendum.pdf](https://www.esma.europa.eu/sites/default/files/library/esma71-1154262120-153_guidelines_for_the_assessment_of_knowledge_and_competence_corrigendum.pdf).

<sup>25</sup> *Guidelines on certain aspects of the MiFID II suitability requirements*, ESMA, 6 November 2018, [https://www.esma.europa.eu/system/files\\_force/library/esma35-43-1163\\_guidelines\\_on\\_certain\\_aspects\\_of\\_mifid\\_ii\\_suitability\\_requirements\\_0.pdf?download=1](https://www.esma.europa.eu/system/files_force/library/esma35-43-1163_guidelines_on_certain_aspects_of_mifid_ii_suitability_requirements_0.pdf?download=1)

<sup>26</sup> For a general reference on how Fintech is impacting or could impact securities markets, please see the "IOSCO Research Report on Financial Technologies (Fintech), Report of the Board of IOSCO, 8 February 2017, <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf> and the "Update to the Report on the IOSCO Automated Advice Tools Survey", Report of the Board of IOSCO, 21 December 2016, <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD552.pdf> However, it should be noted that neither the Review Team nor the AC considered these or other IOSCO reports on the subject matter for the assessment. Therefore, these reports are mentioned here only as being related to the types of Fintech developments identified in this Report.

questionnaire designed to isolate certain aspects of a customer's investment objectives, time horizons, financial circumstances and risk tolerance. The regulatory challenges presented by digital advisors include questions about the validity of the underlying investment-choosing algorithms and the adequacy and quality of the customer data sought by these firms, upon which those algorithms rely. Similar concerns may exist where online platforms provide personal or generic recommendations without the ability to execute transactions automatically.

Online trading platforms present different concerns. On one hand, these platforms generally execute transactions, or route them for execution, and do not provide advice. On the other hand, they often target retail clients and may offer particularly complex or risky products, such as contracts for difference, binary options, and access to the equity and debt securities of companies raising funds via crowdfunding. To the extent platform trading is self-directed (i.e., execution-only transactions), a number of responses indicated that, in some jurisdictions, uncertainty regarding the appropriate levels of regulatory intervention remains.

The Review Team observed some Participating Jurisdictions to have provided guidance on the application of their regulatory requirements to the digital or online space. For example:

- Multiple provincial regulators in Canada, including the Autorité des marchés financiers (AMF) of Québec and the Ontario Securities Commission (OSC), have published a Canadian Securities Administrators (CSA) Staff Notice providing guidance to portfolio managers on operating online platforms in compliance with regulatory requirements;<sup>27</sup>
- Guidelines in Hong Kong establish specific requirements for robo-advisors relating to customer information, algorithm development and testing, and staff knowledge and expertise;<sup>28</sup>
- In the United States, FINRA issued a report reminding its members of their obligations under FINRA rule and to share effective practices related to digital investment advice;<sup>29</sup>

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<sup>27</sup> The Canadian Securities Administrators (CSA) is an umbrella organization of Canada's provincial and territorial securities regulators whose objective is to improve, coordinate and harmonize regulation of the Canadian capital markets.  
[http://www.osc.gov.on.ca/en/SecuritiesLaw\\_csa\\_20150924\\_31-342\\_portfolio-managers-online-advice.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20150924_31-342_portfolio-managers-online-advice.htm)

<sup>28</sup> Securities and Futures Commission (SFC) Guidelines on Online Distribution and Advisory Platforms:  
<https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/guidelines-on-online-distribution-and-advisory-platforms/guidelines-on-online-distribution-and-advisory-platforms.pdf>

<sup>29</sup> Report on Digital Investment Advice  
<https://www.finra.org/sites/default/files/digital-investment-advice-report.pdf> The SEC oversees FINRA, a self-regulatory organization that is registered with the SEC as a securities association.

- In South Africa, Section 38 of the Determination of Fit and Proper Requirements for Financial Services Providers, which took effect in 2018, establishes requirements for creating and testing algorithms;<sup>30</sup> and
- The Monetary Authority of Singapore (MAS) issued guidelines on Digital Advisory Services, which address governance and supervision of algorithms and the standard of care expected of intermediaries.<sup>31</sup>

Other jurisdictions have taken different or additional measures, including bans on certain distributions channels, to curtail certain complex financial products and FinTech-related risks.<sup>32</sup> The Review Team covered these and other regulatory approaches, as appropriate, in the principle-by-principle discussion, which follows below.

Neither the 2013 Report nor the Questionnaire discussed or inquired about developments in RegTech, specifically. Some Participating Jurisdictions, however, included in their responses information regarding their use of RegTech in connection with their supervisory programs. For example, Ireland reported that the use of technology creates efficiencies, which allows supervisory teams to focus on thematic work on higher risk areas, while Singapore reported having established a dedicated unit to focus on conduct surveillance and analytics, including monitoring of industry trends and financial advisory sector analytics. The Review Team did not address RegTech any further in this report.

In May 2018, IOSCO launched a FinTech Network, which was created to facilitate the sharing of information and knowledge on Fintech developments. While the Network's current work-streams do not directly address developments around complex financial products, jurisdictions may still wish to consider their output in connection with the recommendations arising from this Review. Those work-streams include: Distributed Ledger Technology (DLT), RegTech, Lessons Learned from Innovation, and the risks, benefits and opportunities of Artificial Intelligence (AI)/Machine Learning (ML).

### 4.3. Principle-by-Principle Analysis

#### 4.3.1. Principle 1 – Classification of Customers

**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*

<sup>30</sup> <https://www.fsca.co.za/Notices/Board%20Notice%20194%20of%202017.pdf>

<sup>31</sup> <http://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Fund-Management/Guidelines-on-Provision-of-Digital-Advisory-Services--CMGG02.pdf>

<sup>32</sup> Regulators in France and Belgium have prohibited online offers of OTC binary options, CFDs and foreign exchange contracts.

*products. The regulator should consider providing guidance to intermediaries in relation to customer classification.*

In the context of the 2013 Report, Principle 1 seeks to ensure that intermediaries give due consideration to the sophistication of their customers when recommending complex financial products. Generally, this entails distinguishing retail customers from non-retail (often referred to as professional customers) based on their relevant financial market knowledge and experience and their financial position. More specifically, this Principle and its MoI point to customers' abilities to understand the risks associated with the relevant products and to make independent investment decisions in making this distinction. Central to this Principle is the expectation that intermediaries consider the complexity and riskiness of different products.

The MoI for this Principle suggest criteria upon which intermediaries may base their customer classifications. They introduce the idea of regulatory protection in respect of intermediaries' duties toward their customers, such as suitability requirements, which should align with those classifications. While discouraging intermediaries from relying solely on customers' requests for non-retail status, the MoI encourage flexibility for otherwise non-retail customers to be able to request classifications affording greater levels of protection.

To be rated 'Fully Consistent' a regime should require intermediaries to distinguish between retail and non-retail customers, while providing criteria to support this classification that duly consider the riskiness or complexity of relevant financial products. Only seven Participating Jurisdictions earned this rating.<sup>33</sup>

The Review Team rated 17 jurisdictions 'Broadly Consistent'.<sup>34</sup> Each of these jurisdictions demonstrated strong customer classification regimes, and many of them provide specifically for consideration of product complexity or riskiness in some cases, such as with 'assessed Professional Clients' in the DIFC and 'elective,' or 'opt-up' professional clients in MiFID II jurisdictions. These jurisdictions did not require consideration of product risk and complexity in connection with the classification of some customers.

For example, in the EU, according to MiFID II, a professional client is a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs. In this respect MiFID II identifies a narrow list of clients presumed to possess such market knowledge and experience, based on their nature/level of sophistication (e.g. regulated firms, institutional investors or large companies with high annual turnover or balance sheet size).<sup>35</sup> These customers are in principle regarded as professionals per se.

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<sup>33</sup> China, Hong Kong, Japan, Ontario/Quebec, Singapore and the United States.

<sup>34</sup> Belgium, Brazil, DIFC, France, Germany, Indonesia, Ireland, Italy, Republic of Korea, Poland, Portugal, Russia, Spain, Sweden, Switzerland, Turkey and the United Kingdom.

<sup>35</sup> Many of the jurisdictions rated Broadly Consistent rely on presumptions in assigning non-retail status to certain types of customers. Without taking a view on the presumptions, themselves, the RT notes the MoI for this Principle encourages caution, where jurisdictions rely on such presumptions, to ensure they do not inappropriately limit the reach of suitability protections while also suggesting that experience in the recent financial crisis exposed inaccuracies in these presumptions, particularly in respect of public entities.

Nevertheless, any such customer has to be informed of this classification by the intermediary before the provision of services and may request to be treated as retail client when it deems it is unable to properly assess or manage the risks involved. Other types of clients (including wealthy natural persons) are considered retail customers unless they request in writing to be treated as professionals. In this case, no presumption applies, and intermediaries have to make their own assessment of the expertise, experience and knowledge of the client following the process and criteria established in EU law. This approach appears to be Broadly Consistent with this Principle.

The Review Team rated the Bahamas ‘Partly Consistent’ in that it recommends rather than requires the classification of customers and the procedures for assigning classification (professional, sophisticated, and retail) do not consider the complexity or riskiness of relevant financial products.<sup>36</sup> While the Review Team rated South Africa as ‘Not Consistent’ to reflect the absence of any current classification requirements in that jurisdiction, we acknowledge anticipated legislation, which is in progress and is expected to include classification requirements, and the default position to extend all relevant protections indiscriminately to all clients.

The MoI provide that, in connection with ongoing client relationships, intermediaries should be required to obtain updated or additional information from clients to validate classifications and to take appropriate action whenever they determine a client no longer to fulfill requirements for non-retail status. Interestingly, many Participating Jurisdictions, such as EU jurisdictions and Turkey, place the onus on professional clients to notify intermediaries of changes to the information forming the basis for their classification, rather than putting said burden on the intermediaries. Additionally, while many jurisdictions required intermediaries to take ‘appropriate actions’ when they determine a customer no longer to meet the criteria for non-retail status, most jurisdictions did not define or explain the actions intermediaries would be expected to take. Notably, the Japanese regime requires intermediaries to reassess customers’ classifications periodically and, in doing so, to examine transactional activity (e.g., transaction frequency, trading losses) and, where appropriate, interview customers. Additionally, the United States’ regime requires broker-dealers to, among other things, attempt to update certain account information every 36 months from the date of the last recommendation regarding accounts for which they were required to make a suitability determination.

#### **4.3.2. Principle 2 – General Duties Irrespective of Customer Classification**

**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 or mitigate conflicts of interest through implementing appropriate procedures in the distribution of complex financial products, and where there exists a potential*

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<sup>36</sup> Bahamas is the only jurisdiction rated ‘Partly Consistent.’ Morocco, Papua New Guinea and South Africa were each rated ‘Not Consistent.’

*risk of damage to the customer’s interest, the intermediaries should, where appropriate, be required to clearly disclose the risk.*

Principle 2 seeks to establish an overarching duty of care in respect of intermediaries’ conduct toward customers. This Principle and its MoI articulate unconditional standards of conduct toward customers not subject to waiver or disapplication based on customer classification, as are other client protections in some jurisdictions.

The Review Team found that the majority of Participating Jurisdictions have one or more principles or rules that establish a duty to act honestly, fairly and professionally (or some similar standard) and to identify, mitigate and manage conflicts of interest. Twenty-three out of 28 jurisdictions earned a ‘Fully Consistent’ rating for this Principle.<sup>37</sup> The Review Team rated three other jurisdictions to be ‘Broadly Consistent’ because, while they have measures addressing conflicts management and prevention, elements of these regimes have weaknesses that impede full consistency with the Principle.<sup>38</sup> For example, in Korea disclosure is only required when the intermediary has a significant interest in the price or sale of the financial investment; and the scope of conflicts covered by the regimes in the Bahamas and Indonesia are restrictively narrow. The Review Team rated two jurisdictions ‘Not Consistent’ because they are each in the process of developing their foundational regime, without which Principle 2 cannot be achieved.<sup>39</sup>

Several jurisdictions’ Questionnaires highlighted an apparent connection between Principle 2 and Principle 8, the latter addressing incentive policies and staff remuneration. More specifically, many jurisdictions rely on the same overarching standard of care principles to fulfil Principle 8 as they do to fulfil Principle 2, here. The Review Team acknowledges the potential for overlap between these two Principles in their coverage of remuneration models as a source of conflicts of interest and explains further its assessment approach under Principle 8, which follows later in this report.

#### **4.3.3. Principle 3 – Disclosure Requirements**

**Principle 3.** *Customers should receive or have access to material information to evaluate the features, costs and 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.*

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<sup>37</sup> Belgium, Brazil, China, DIFC, France, Germany, Hong Kong, Ireland, Italy, Japan, Ontario/Quebec, Poland, Portugal, Russia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

<sup>38</sup> Bahamas, Indonesia, and Republic of Korea.

<sup>39</sup> See discussion of Morocco and Papua New Guinea in Section 4.2.3.

This Principle expects jurisdictions to require intermediaries to communicate information to customers in a clear and helpful manner and to apply disclosure requirements whenever an intermediary advises or recommends the purchase of a complex financial product. The Review Team assessed a majority (19 out of 28) of Participating Jurisdictions to be ‘Fully Consistent’ with Principle 3.<sup>40</sup> These jurisdictions have overarching requirements for communications to be clear and not misleading and/or have prescribed disclosures that are fair, comprehensible and balanced, although not all of these jurisdictions differentiate the complexity of the financial products in applying these requirements. Additionally, these jurisdictions require intermediaries’ disclosures to contain material information such as the features, costs and risks of the financial product.

The Review Team rated three jurisdictions as ‘Broadly Consistent’ with the Principle because, while they have disclosure requirements covering most elements of the Principle, some elements mapping to the MoI were less robust.<sup>41</sup> The Review Team rated three jurisdictions as ‘Partly Consistent.’ In Turkey, intermediaries must make certain disclosures at the time of account opening in considering the suitability of the services envisioned. The remaining jurisdictions require intermediaries to disclose only ‘sufficient’ or ‘important’ information.<sup>42</sup> These requirements may not ensure intermediaries provide customers enough or appropriate information about the features, costs and risks of the relevant complex product or transaction, which are addressed specifically in this Principle.

The Participating Jurisdictions use a range of terminology to describe their disclosure requirements. This includes terms like reliable, clear, not false or misleading, sufficient, friendly, meaningful and complete. Notwithstanding, jurisdictions appear to achieve disclosure outcomes consistent with this Principle.

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<sup>40</sup> Belgium, China, France, Germany, Hong Kong, Indonesia, Ireland, Italy, Japan, Ontario/Quebec, Poland, Portugal, Russia, Singapore, Spain, Sweden, the United Kingdom, and the United States.

<sup>41</sup> Republic of Korea, South Africa, and Switzerland.

<sup>42</sup> Bahamas, Brazil, and Turkey.

Most jurisdictions prescribe the basic level of disclosure needed for customers to make an informed decision, such as the features, risks and costs of all financial products, rather than just merely providing access to key product information.<sup>43</sup> MiFID II-based jurisdictions require intermediaries to disclose whether or not they provide advice on an independent basis and to provide retail customers with a report that outlines the advice given and explains why the recommendation is suitable in light of the client's objectives and personal circumstances.

Notably, only one of the Participating Jurisdictions, China, specifically requires intermediaries to provide customers with comparative information concerning appropriate alternative products (e.g., less complex, less costly), as suggested by the MoI.<sup>44</sup> However, in Brazil, intermediaries must have internal policies and procedures related to recommendations of complex products in order to highlight to customers the risks of structured products as compared to traditional products and the potential difficulty in determining their value.

**Product-specific Requirements:**

ESMA's product interventions, effective 1 August 2018, require CFD providers to use a standardized risk warning, including the percentage of losses in retail investors' accounts. The DFSA expects CFD providers to provide a similar risk disclosure to ensure information about the riskiness of these products is sufficiently clear and available to potential investors.

Some Participating Jurisdictions prescribe additional requirements specifically for retail customers, such as requirements for disclosures to be user-friendly, in readable fonts and easily understood.<sup>45</sup> Others prescribe the format in which key information must be presented<sup>46</sup> or have additional product-specific risk disclosure requirements.<sup>47</sup> A majority of the Participating Jurisdictions require a prospectus in connection with public offers.<sup>48</sup> Notably, China requires intermediaries to make video and audio recordings of the full processes through which they issue notifications and warnings to customers.

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<sup>43</sup> All Participating Jurisdictions (except DIFC and Papua New Guinea) have specific product disclosure regimes, while Morocco is in the process of implementing legislative requirements relating to disclosure requirements.

<sup>44</sup> Similarly, FINRA Regulatory Notice 12-03, which addresses complex products, directs registered representatives to consider whether less complex or costly products could achieve the same objectives for their customers.

<sup>45</sup> Belgium, France, Germany, Hong Kong, Ireland, Italy, Japan, Ontario/Quebec, Portugal, Russia, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

<sup>46</sup> See the Key Information Document (KID) for Packaged Retail Investment and Insurance-Based Products (PRIIPs) and the Key Investor Information Document (KIID) for Undertakings for Collective Investment in Transferable Securities (UCITS); and Singapore's Product Highlight Sheet (see *Practice Note on the Product Highlight Sheet*, Singapore MAS, June 2018, available at: [https://www.mas.gov.sg/-/media/MAS/resource/legislation\\_guidelines/securities\\_futures/sub\\_legislation/Practice-Note-on-the-Product-Highlights-Sheet-SFA-PN-02.pdf](https://www.mas.gov.sg/-/media/MAS/resource/legislation_guidelines/securities_futures/sub_legislation/Practice-Note-on-the-Product-Highlights-Sheet-SFA-PN-02.pdf)).

<sup>47</sup> Specific product disclosures are required for contracts for differences in Singapore, crowdfunding in the DIFC and Singapore, marginable instruments in Singapore and United States, variable annuities and day trading in United States.

<sup>48</sup> Belgium, China, France, Germany, Hong Kong, Ireland, Italy, Japan, Ontario/Quebec, Poland, Portugal, Republic of Korea, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

#### 4.3.4. Principle 4 – Protection of Customers for Non-Advisory Services

**Principle 4.** *When an intermediary sells 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 associated risks.*

Principle 4 seeks to ensure that, in situations where clients select a complex product without professional advice or management (e.g., unsolicited or execution-only transactions), some protection of clients' interests remain. The MoI encourage requirements for intermediaries to assess the client's relevant knowledge and experience, to disclose product features and the risks associated with the transaction, and to warn clients where it believes a proposed transaction not to be appropriate.

The MoI also promote strong governance related to the offering of complex products, involving heightened transaction controls and consideration of the advisability of certain complex products – including access to platforms on which to trade complex products – for particular clients or types of clients, such as retail investors.

A 'Fully Consistent' regime would ensure that intermediaries identify and intervene in unsolicited transactions in complex products by providing relevant information to clients and/or by considering the riskiness and complexity of them against the relevant client profiles.<sup>49</sup>

Three-quarters of the Participating Jurisdictions (21 out of 28) earned a 'Fully Consistent' rating.<sup>50</sup> MiFID II jurisdictions generally require intermediaries, in connection with unsolicited trades, to obtain and consider information about a customer's knowledge and experience in respect of the relevant product or service to determine whether it is appropriate for that person.<sup>51</sup> Where an intermediary believes an unsolicited order not to be appropriate for a customer or where it does not have sufficient information to make such a determination, it must so warn the customer, but may proceed to execute the transaction should the customer insist. In the Republic of Korea, in connection with non-advised transactions in complex products, where intermediaries determine the product not to be adequate for an ordinary investor (considering the investment purpose, status of property, and the investment experience), the intermediary must notify the investor and obtain a written confirmation of his intention to

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<sup>49</sup> Depending on the nature of the relevant protections, this may involve considering the profile, including investment needs and objectives, knowledge and experience, and risk tolerance, of a particular customer or that of a particular type of customer.

<sup>50</sup> Belgium, Brazil, China, France, Germany, Hong Kong, Indonesia, Ireland, Italy, Japan, Republic of Korea, Ontario/Quebec, Poland, Portugal, Singapore, Spain, Sweden, Turkey, the United Kingdom, and the United States.

<sup>51</sup> MiFID II provides a carve-out from its appropriateness requirements for specific non-complex products.

proceed. Additionally, Korean intermediaries must record the sales process whenever they sell complex products to elderly persons over the age of 70.<sup>52</sup>

In Hong Kong, intermediaries are required to provide clients without knowledge of derivatives who seek to trade derivatives over the counter with a warning about the relevant transaction and advice as to whether or not they believe the transaction to be suitable for the client. Where an intermediary determines a proposed transaction in such complex products not to be suitable for a customer, it may not proceed with that transaction for that customer, even if the customer insists.<sup>53</sup> The regime in the United States requires intermediaries to consider a customer's knowledge and experience in respect of certain complex products before approving the customer to trade them.<sup>54</sup>

The Review Team rated another two jurisdictions as 'Broadly Consistent.'<sup>55</sup> Generally, each of these regulatory systems had strong protections; however, those protections provided only partial coverage in respect of either or both of the complex products and customer groups

**FinTech Note:**

In Hong Kong, Guidelines for Online Distribution and Advisory Platforms took effect in July 2019. These guidelines establish, among other things, a requirement for platform operators to ensure the suitability of all transactions in complex products, including unsolicited transactions.

present in those jurisdictions. The Review Team rated Russia 'Partly Consistent' because of the way the system limits access to many complex products to Qualified Investors, which comports with certain relevant MoI. The remaining four Participating Jurisdictions were rated 'Not Consistent.'<sup>56</sup>

Types of controls present in other highly rated jurisdictions include but are not limited to restrictions on the promotion or distribution of certain complex products to certain customer types, such as retail investors;<sup>57</sup> limiting execution-only delivery channels

<sup>52</sup> Enforcement Decree Article 68(5)2-2 FSCMA.

<sup>53</sup> SFC Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission: <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission.pdf> and also SFC Guidelines on Online Distribution and Advisory Platforms: <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/guidelines-on-online-distribution-and-advisory-platforms/guidelines-on-online-distribution-and-advisory-platforms.pdf>.

<sup>54</sup> These requirements apply in respect of customers wishing to trade index warrants, currency index warrants, and currency warrants; options; and securities futures. See FINRA Rules 2353,2360(b)(19), and 2370(b)(19).

<sup>55</sup> South Africa and Switzerland.

<sup>56</sup> Bahamas, DIFC, Morocco, and Papua New Guinea.

<sup>57</sup> For example, the United Kingdom prohibits the promotion of 'non-readily realisable securities' and 'non-mainstream pooled investments' to less-sophisticated investors, while European regulators must restrict the marketing, distribution or sale of certain complex products to retail investors, pursuant to ESMA product intervention measures published on 1 June 2018 (and subsequently renewed).

only to non-complex products;<sup>58</sup> and mandatory risk disclosures. In France<sup>59</sup> online offers of over-the-counter binary options, contracts for differences and foreign exchange contracts are prohibited. In Belgium, Financial Services and Markets Authority (FSMA) regulations prohibit distribution to consumers, on a professional basis, any derivative instrument traded via an electronic system, where those instruments are binary options, have a duration of less than one hour, or involve leverage, directly or indirectly.<sup>60</sup> Similarly, Ontario and Quebec have banned binary options for retail clients, while in Quebec qualified persons must obtain regulatory approval before offering CFDs and FX forwards to retail clients.<sup>61</sup> In Singapore, upon receiving an unsolicited order for a complex product, intermediaries must consider the client's profile and offer to provide appropriate advice in respect of the transaction, although clients may still elect not to take up that offer of advice.

#### **4.3.5. Principle 5 – Suitability Protections for Advisory Services**

**Principle 5.** *Whenever an intermediary recommends the purchase of 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.*

Principle 5 seeks to ensure that, where an intermediary recommends a particular complex product, the intermediary has considered sufficient relevant information to determine that product to be suitable for that customer at that time. The MoI provide more granular direction on the nature and scope of customer and product-specific information critical to this assessment.<sup>62</sup> In rating jurisdictions, the Review Team identified three essential elements to this assessment: (1) developing a customer's 'investor profile;' (2) conducting product due diligence; and (3) matching the outcomes of (1) and (2) to select a financial product suitable

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<sup>58</sup> Sweden; Chapter 9, Article 25 Securities Markets Act.

<sup>59</sup> France's additional online investor protections cover binary options, CFDs, and forex products: *Monetary and financial code*, 9 December 2016, Article 533-12-18; and see also *General Regulation of the Autorité des marchés financiers* available at: <https://www.amf-france.org/eli/fr/aai/amf/rg/20161218/en.pdf>.

<sup>60</sup> *Regulation regulating the distribution of certain derivative financial instruments to retail clients*, Belgium FSMA, 26 May 2016, available at: [https://www.fsma.be/sites/default/files/public/reglem\\_26-05-2016\\_en.pdf](https://www.fsma.be/sites/default/files/public/reglem_26-05-2016_en.pdf). A consumer, as that term is used here, is a natural person who is acting for non-professional purposes, excluding a consumer who is treated as a professional investor (on request) under the MiFID categorisation scheme.

<sup>61</sup> See Multilateral Instrument 91-102 Prohibition of Binary Options at [www.osc.gov.on.ca/en/54014.htm](http://www.osc.gov.on.ca/en/54014.htm). In Ontario an entity offering CFDs and FX forwards to retail clients will generally be subject to securities law requirements.

<sup>62</sup> While the MoI for Principle 5 also address competency expectations for intermediaries' sales staff, the Review Team has addressed this with its discussion of Principle 6, which also touches on this issue.

for the customer. The Review Team’s observations in respect of each of these elements are presented below.

### *Assessment Results*

Participating Jurisdictions needed to demonstrate that their regulatory system covered each of the three elements to earn a rating of at least ‘Partly Consistent.’ Jurisdictions providing greater levels of detail and specific direction earned ratings of ‘Fully Consistent.’ Thematically, where the Review Team rated jurisdictions as ‘Broadly Consistent’ with Principle 5, the Review Team observed strong customer profiling expectations alongside less-robust product due diligence requirements. In assessing jurisdictions with principles-based regimes with fewer detailed or prescriptive requirements, the Review Team considered additional information such as the regulator’s expectations regarding compliance with suitability requirements, how regulators communicate their expectations to intermediaries, and market context and sophistication, amongst other things.

The Review Team rated 18 of the 28 Participating Jurisdictions as ‘Fully Consistent’ with Principle 5.<sup>63</sup> These jurisdictions reported having detailed requirements in respect of both customer and product-specific information intermediaries must consider. The Review Team rated six jurisdictions ‘Broadly Consistent.’<sup>64</sup> These jurisdictions reported strong customer profiling requirements while having less-robust product due diligence coverage. Russia earned a rating of ‘Partly Consistent’ by demonstrating its system’s coverage of the three essential elements, though not sufficiently robustly to achieve a higher rating. The Review Team rated three jurisdictions ‘Not Consistent’.<sup>65</sup>

Notably, none of the Participating Jurisdictions reported having a suitability regime specifically for complex products. Generally, as observed in the 2013 Report, jurisdictions have one suitability framework that applies to any recommendation or discretionary decision, irrespective of the nature or complexity of the subject instruments, though most expect product complexity to factor into suitability assessments in some way. Certain jurisdictions, however, did report additional requirements, such as additional customer information and more extensive product reviews, to enhance controls specifically around complex products. In the US, FINRA has issued several rules to its members requiring heightened suitability consideration of certain, specifically identified complex products, including variable annuities, options, and security futures.

### *Customer Profiling*

Common themes in respect of customer information included investment objectives, financial circumstances and risk profile. The Review Team also observed certain less common, but noteworthy requirements, as explained here. Japanese intermediaries must obtain and consider

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<sup>63</sup> Belgium, Brazil, China, France, Germany, Hong Kong, Ireland, Italy, Japan, Ontario/Quebec, Poland, Portugal, Singapore, Spain, Sweden, the United Kingdom and the United States.

<sup>64</sup> DIFC, Indonesia, Republic of Korea, South Africa, Switzerland and Turkey.

<sup>65</sup> Bahamas, Morocco, and Papua New Guinea.

information on the trading losses and the status of fee payments of customers. Similarly, intermediaries in China must assess the creditworthiness of customers. In Ireland, retail intermediaries must consider a customer's personal circumstances including, where relevant, health, in connection with a suitability assessment and record material changes to a customer's circumstances prior to offering or recommending financial products. In the US, FINRA encourages intermediaries to adopt more stringent approaches to consider customers' investment objectives and risk tolerances when recommending complex products.

### *Product Due Diligence*

Most jurisdictions required intermediaries to consider products' risks and features. In the United States, FINRA rules require intermediaries to undertake due diligence to form a reasonable basis to believe a recommendation, which may involve a product or a strategy, is suitable for at least some investors. In conducting product due diligence, intermediaries in Singapore must consider whether additional measures would be necessary to mitigate conflicts of interest before selling or marketing any new product to targeted customers. While the DIFC does not have explicit product due diligence requirements, the DFSA communicates its expectations to intermediaries through annual industry outreach events.

As addressed above, the concept of product complexity varied amongst Participating Jurisdictions. Correspondingly, the Review Team observed that jurisdictions with fewer complex products tended to have less-rigorous product due diligence requirements.

### *'Matching'*

While the majority of highly rated participants did not have explicit customer and product matching requirements, they explained this to be implied in their regulatory system and carried out by intermediaries in practice. In connection with matching, several jurisdictions require intermediaries to consider the composition of a customer's portfolio when providing portfolio management or advice.<sup>66</sup> FINRA's suitability rules in the United States also scope in consideration of investment strategies, including recommendations to hold securities. Notably, Ireland requires MiFID-exempt firms to ensure that a recommended product is "the most suitable" product for the customer.

### *Other Suitability Policy*

The Review Team observed that some Participating Jurisdictions allow intermediaries to limit or waive suitability requirements, in whole or in part, for customers classified as non-retail.<sup>67</sup> Conversely, German regulations require intermediaries to ensure the suitability of any investment advice, irrespective of customer classification. Similarly, in Hong Kong, intermediaries must ensure suitability when soliciting or recommending any investment product to customers who are individuals, whether classified as professional or retail.

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<sup>66</sup> MiFID II jurisdictions, Hong Kong, Ontario/Quebec, Switzerland and the United States.

<sup>67</sup> DIFC

Some Participating Jurisdictions reported having other regulatory measures that, while not necessarily suitability-specific, seek to address risks complex products pose to different customer types. Japan has issued supervisory guidelines on the accountability of intermediaries selling certain complex products (e.g., interest rate swaps) and rules prohibiting solicitation of complex structured bonds similar to over-the-counter derivatives to certain customers. In Italy, Consob urges intermediaries to set concentration limits for client portfolios when distributing complex products and to refrain from recommending or distributing to retail clients certain types of particularly complex products (e.g. CoCos, ABS, structured and credit-linked instruments). At the time of the Review, certain European jurisdictions had also restricted the distribution of certain complex products to retail investors,<sup>68</sup> efforts which were subsequently reinforced by ESMA’s exercise of product intervention powers.<sup>69</sup>

#### **4.3.6. Principle 6 – Sufficient Information/Reasonable Basis**

**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.*

The objective of this Principle is to provide a standard for intermediaries to have sufficient information about their customers and the relevant products to support recommendations or discretionary decisions involving complex products. Principle 6 builds on the assessment expectations of Principle 5 to establish a *reasonable* basis standard in respect of suitability. The MoI emphasize, in particular, approaches for intermediaries to deal with shortcomings in the information they have about customers and expectations in respect of intermediaries’ understanding of the products they recommend.<sup>70</sup>

To achieve a ‘Fully Consistent’ rating, Participating Jurisdictions demonstrated: (1) requirements for intermediaries to gather sufficient information about customers; (2) the presence of safeguards to address situations where a customer fails to provide sufficient information; (3) requirements for intermediaries to have or obtain sufficient information in order to understand the relevant products; and (4) continuing education or training requirements for intermediaries’ staff. Generally, the Review Team rated jurisdictions demonstrating any three of these four factors as ‘Broadly Consistent,’ while rating jurisdictions

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<sup>68</sup> Belgium, France, Italy, Spain and the United Kingdom.

<sup>69</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-adopts-final-product-intervention-measures-cfds-and-binary-options>

<sup>70</sup> The MoI for Principle 6 also address product interventions, which the Review Team has addressed in connection with Principle 4 and Principle 5.

demonstrating any two of them as ‘Partly Consistent.’<sup>71</sup> The Review Team rated 17 of the 28 Participating Jurisdictions ‘Fully Consistent’ with Principle 6.<sup>72</sup>

The Review Team’s assessments of these information requirements built off the customer profiling and product due diligence results from Principle 5. MiFID II jurisdictions require intermediaries to take reasonable steps to ensure that the information collected about their clients is reliable through, for example, ensuring all tools employed in the suitability assessment are fit-for-purpose and are appropriately designed, and ensuring questions used are likely to be understood by clients. In cases where an intermediary does not have sufficient customer information, several Participating Jurisdictions explicitly prohibit the intermediary from making a recommendation or exercising investment discretion.<sup>73</sup> Six jurisdictions reported having requirements for intermediaries to warn customers either of the consequences of having limited information or that any recommendation is based only upon the limited information on hand.<sup>74</sup> In Singapore, in connection with over-the-counter transactions involving complex products, where a customer does not provide the required information, an intermediary must consider the customer as not to possess knowledge or experience in respect of the relevant product and must offer to provide advice.

Several Participating Jurisdictions have continuing staff competency requirements. European jurisdictions operating under MiFID II tended to have explicit requirements for intermediaries

**FinTech Note:**

In 2016, Belgium banned the distribution via electronic trading platforms of binary options and certain short-term and leveraged derivatives. Also, in 2016, France banned the advertising through electronic means of certain highly speculative and risky financial contracts to private individuals.

to understand the financial instruments it offers or recommends. Rules in the DIFC require intermediaries to ensure their employees are competent and capable of performing assigned functions, which includes the giving of advice. The regulatory system in the United Kingdom requires intermediaries to ensure that their staff have the skills, knowledge and expertise needed to discharge the responsibilities of their role. Ireland’s Minimum Competency Code establishes specific qualification, continuing education, experience and supervision requirements for persons who provide

advice or information to retail and elective professional customers. In South Africa, staff must complete product-specific training and an assessment before being allowed to give advice and must receive further training, subject to assessment, in connection with changes or updates to products. In Singapore, intermediaries must assess the minimum qualifications or training necessary for an employee to make recommendations.

<sup>71</sup> Broadly Consistent (5): Brazil, Indonesia, South Africa, Switzerland and Turkey; Partly Consistent (3): DIFC, Republic of Korea, and Russia; Not Consistent (3): Bahamas, Morocco, and Papua New Guinea.

<sup>72</sup> Belgium, China, France, Germany, Hong Kong, Ireland, Italy, Japan, Ontario/Quebec, Poland, Portugal, Singapore, Spain, Sweden, the United Kingdom and the United States.

<sup>73</sup> MiFID jurisdictions, Brazil, Canada, China, Japan, Korea, and Turkey.

<sup>74</sup> Belgium, China, Hong Kong, Singapore, South Africa and Switzerland.

#### 4.3.7. Principle 7 – Compliance Function

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

Principle 7 builds on earlier IOSCO work to emphasize the role of an intermediary's compliance function to fulfil suitability requirements in respect of complex products.<sup>75</sup> The MoI promote written policies and procedures supported by internal reporting and communication frameworks. The MoI also encourage ongoing efforts by intermediaries to ensure their product offerings, including products they develop, remain appropriate for their target client market and to ensure that related systems and controls continue to function effectively.

The Review Team determined a 'Fully Consistent' regime would have, at a minimum, requirements for intermediaries to have a compliance function empowered to establish and enforce policies and procedures to ensure fair treatment of its customers, including compliance with suitability requirements. A majority of Participating Jurisdictions (19 out of 28) require a compliance function charged with overseeing the distribution and sale of complex products.<sup>76</sup> These jurisdictions each earned ratings of 'Fully Consistent' here. The Review Team noted strong approaches in European regimes that must comply with MiFID II, which specifically requires a compliance function and sets standards for suitability assessments based on the extent to which products meet the needs of predefined target client groups.

The Review Team rated five regimes as 'Broadly Consistent.'<sup>77</sup> These jurisdictions generally reported requiring intermediaries to have a compliance function, though with less-robust or less-specific requirements in respect of the internal processes addressed in the MoI. In the DIFC, product target market expectations apply only in the context of retail OTC derivatives. The regulatory system in Brazil mandates a compliance function within an intermediary to ensure that it complies with sets of rules established by the intermediary, itself. This framework expects that intermediaries will embed in these rules suitability-related principles set forth by the regulator.

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<sup>75</sup> See *Compliance Function at Market Intermediaries – A report of Technical Committee of the IOSCO*, of March 2006 where IOSCO advocated the establishment by intermediaries of a compliance function proportionate to the scale and type of their business. Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD214.pdf>.

<sup>76</sup> Belgium, Brazil, China, France, Germany, Hong Kong, Indonesia, Ireland, Italy, Japan, Ontario/Quebec, Poland, Portugal, Singapore, Spain, Sweden, the United Kingdom, and the United States.

<sup>77</sup> DIFC, Republic of Korea, South Africa, Switzerland, and Turkey.

The regimes in Bahamas and Russia, which both earned ratings of ‘Partly Consistent’, feature broad principles requiring firms to abide by the regulatory regime, but do not have specific, or more granular rules or guidelines to explain how firms are expected to govern themselves.<sup>78</sup>

#### 4.3.8. Principle 8 – Incentives

**Principle 8.** *Intermediaries should be required to develop and apply appropriate incentive policies designed to ensure that only suitable complex financial products are recommended to customers.*

Based on the premise that sales of complex products often generate higher commissions through more difficult to understand charge structures, Principle 8 seeks to promote employee remuneration practices that prioritize customers’ best interests. The MoI encourage, among other things, senior management accountability to ensure remuneration policies do not create incentives or pressures to recommend complex financial products when other products would better meet customers’ needs.

A ‘Fully Consistent’ regime would have rules or principles addressing standards for remuneration or incentive policies and would require senior management engagement. The Review Team faced certain challenges in rating jurisdictions against this Principle. While some jurisdictions’ frameworks specifically address standards or requirements for intermediaries’ remuneration policies, other regimes codify duties of care and/or requirements for handling conflicts of interest or acting in clients’ best interests (collectively, referred to as ‘best interests requirements’) that they explained extend to remuneration, though not mentioning that or other incentives, specifically. Because the latter case also relates directly to Principle 2, the Review Team discussed how to assess it against this Principle agreeing to rate favorably regimes that the Review Team understands can be applied broadly in this context.

The Review Team rated 16 out of the 28 Participating Jurisdictions ‘Fully Consistent’ because they each have rules or principles that specifically address standards for intermediaries’ remuneration policies or have best interests requirements enabling them to regulate this space.<sup>79</sup> Where regimes addressed remuneration policies specifically, these also required senior management review or approval of them.

The Review Team observed a number of noteworthy practices amongst these jurisdictions. Several jurisdictions require qualitative elements in staff appraisals, such as fulfilment of suitability obligations, handling of complaints and disputes, compliance with regulations and treatment of customers. Some jurisdictions have also imposed restrictions, including prohibitions, on intermediaries’ acceptance of inducements from third parties. In Japan, the regime specifically requires intermediaries to evaluate the performance of risk management and compliance staff separately from business functions and to ensure remuneration of these

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<sup>78</sup> Morocco and Papua New Guinea were rated Not Consistent.

<sup>79</sup> Belgium, China, DIFC, France, Germany, Hong Kong, Ireland, Italy, Japan, Poland, Portugal, Singapore, South Africa, Spain, Sweden, United Kingdom.

functions reflects their importance and contributions to an effective control environment. In Singapore, regulations require intermediaries to stagger payment of commissions for certain life policies over a period of at least six years to promote improved post-sale customer care over simply making the sale, while Ireland provides guidance on variable pay arrangements for sales staff.

The Review Team rated two jurisdictions ‘Broadly Consistent,’ each for different reasons.<sup>80</sup> Korean legislation sets specific standards for intermediaries’ remuneration policies, but provides for senior management oversight and other, more granular, direction only through administrative guidance. The Review Team did observe a noteworthy practice in Korea, which empowers intermediaries to claw back remuneration paid to staff where a client exits a deal due to unfair conduct or mis-selling. The Swiss regime establishes standards in line with Principle 8 and the relevant MoI but applies these only to firms capitalized above a specified threshold.

The Review Team rated five jurisdictions ‘Partly Consistent.’<sup>81</sup> The regimes in Ontario and Quebec appear to address incentives broadly through high-level guidance, while having specific regulations to address incentive-related conflicts in the contexts of mutual fund distribution and underwriting.<sup>82</sup> In Indonesia, regulations require the senior management of investment managers to be responsible for internal control systems, including remuneration schemes. However, while regulations appear to address compensation paid by customers to intermediaries, they do not address remuneration paid by intermediaries to their staff. Notably, several Participating Jurisdictions referenced rules or principles governing the compensation that *intermediaries* receive from or charge to customers, which falls outside of the scope of this principal and, thus, did not bear on ratings.

In the United States, as of the August 2018 date for the Review, there was no specific legislation or regulation that specifically addressed this Principle, giving rise to the rating. The Review Team does not believe that this absence had an adverse impact on the overall suitability regime in the United States in light of its consistency with other Principles and the strength of its other components. FINRA rules restrict intermediaries’ use of non-cash compensation in connection with the sale of and distribution of certain products, some of which are complex products.<sup>83</sup> FINRA has also undertaken a targeted review of broker-dealers’ approaches to identifying and managing conflicts of interest, including how they compensate their associated persons.<sup>84</sup> In

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<sup>80</sup> Republic of Korea and Switzerland.

<sup>81</sup> Indonesia, Ontario/Quebec, Turkey and the United States.

<sup>82</sup> See: [https://www.osc.gov.on.ca/documents/en/Securities-Category3/csa\\_20161215\\_33-318\\_incentives.pdf](https://www.osc.gov.on.ca/documents/en/Securities-Category3/csa_20161215_33-318_incentives.pdf) and <https://lautorite.qc.ca/en/professionals/regulations-and-obligations/securities/8-investment-funds-81-101-a-81-107/81-105-mutual-fund-sales-practices/>. Additionally, Ontario and Quebec reported that they have commenced work on targeted reforms that will address this Principle. This involves rule amendments and detailed guidance regarding conflicts of interest.

<sup>83</sup> See FINRA Rules 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company), and 5110 (Corporate Financing Rule).

<sup>84</sup> See <https://www.finra.org/sites/default/files/Industry/p359971.pdf>.

addition, the SEC approved Regulation Best Interest in June 2019. Once compliance is required, this regulation will require broker-dealers to act in the best interest of a retail customer when making a recommendation without putting the financial or other interest of the broker-dealer ahead of the retail customer.<sup>85</sup>

The Review Team rated five jurisdictions rated ‘Not Consistent’.<sup>86</sup> While Morocco does not yet have relevant requirements, its response demonstrated recognition of these risks and progress toward developing its regime.

#### **4.3.9. Principle 9 – Enforcement**

**Principle 9.** *Regulators 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. The competent authority should take enforcement actions, as appropriate. Regulators should consider the value of making enforcement actions public in order to protect customers and enhance market integrity.*

Principle 9 addresses the means by which regulators ensure that financial intermediaries adhere to the suitability requirements of the preceding Principles. The three key components to a ‘Fully Consistent’ regime include: (1) legal empowerment; (2) supervisory engagement; and (3) a communications channel between the regulatory authority and financial intermediaries. The Questionnaire asked respondents to provide evidence of each of these components.

Legal empowerment means that the regulatory authority has the power to supervise and enforce the suitability regime. Supervision means the ability to request information from firms and/or other market participants. Enforcement means the ability to sanction inappropriate behavior on the part of firms and individuals. Such sanctions may include limitations on activity, monetary fines, suspension, or other directions.

Supervisory engagement ensures the regulatory authority is aware of how financial intermediaries and their employees engage with investors when selling financial products. Regulators may achieve this awareness through supervisory programs that include one or more of the following activities: regular or routine onsite visits, offsite reviews and questionnaires, thematic reviews, mystery shopping, supervisory requests for remediation, consideration of complaints, or other means.

The communication element expects regulators to present the results of supervisory oversight to the intermediary community to ensure their awareness of regulatory expectations. These

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<sup>85</sup> Regulation Best Interest was proposed in April 2018, but because it was not a final rule as of the August 2018 date for this review, the Review Team did not consider it for purposes of the rating and has not evaluated it for consistency with the Principle. See <https://www.sec.gov/rules/final/2019/34-86031.pdf> and <https://www.sec.gov/news/press-release/2019-89>.

<sup>86</sup> Bahamas, Brazil, Morocco, Papua New Guinea, and Russia.

results may take a variety of forms, including reports/results of thematic reviews, outcomes of enforcement actions, FAQs and/or regulatory bulletins, letters to individual firms, training sessions, letters to CEOs, and warnings of intentions or indications that the regulator will take action on account of undesirable behavior.

The Questionnaire asked jurisdictions to provide evidence supporting the presence of these three components. All jurisdictions that were rated ‘Fully Consistent’ provided evidence, which included descriptions of the results of supervisory visits and thematic reviews, fines and administrative sanctions and mystery shopping, amongst other things.

The Review Team rated 18 jurisdictions as ‘Fully Consistent.’<sup>87</sup> Each of these jurisdictions reported using supervisory powers to observe the behavior of financial intermediaries and the willingness to take action in response to observations. They provided evidence including relevant results of supervisory visits and thematic reviews and, in some cases, descriptions of mystery shopping exercises. The vast majority of these jurisdictions reported having imposed fines for inappropriate behavior.

Five jurisdictions earned ratings of ‘Broadly Consistent.’<sup>88</sup> These regimes each reported having the appropriate frameworks in place but provided less-robust evidence to support their effectiveness specifically in regard to suitability and complex products.

The Review Team rated the Republic of Korea and Russia ‘Partly Consistent’ because, while their Questionnaires reported the development of relevant supervisory and enforcement regimes, respectively, the responses did not provide sufficient detail regarding their scope or functionality. The Review Team rated the remaining three Participating Jurisdictions as ‘Not Consistent.’

## 5. RECOMMENDATIONS

The 28 participating jurisdictions represented a segment of IOSCO’s members demonstrating Participating Jurisdictions’ diversity in terms of size, product offering and needs, consumers’ market and behavioral patterns, and degree of development. Indeed, this group included jurisdictions ranging from considerably developed markets, which could feature an array of complex financial products and high levels of market participation, to growth and emerging markets with lower participation rates and one or both of fewer complex products on offer or more products of lesser complexity. Consequently, the Review Team expected and found some variance in consistency levels within this group. The interpretation of the findings should, therefore, take into account the relative characteristics of the Participating Jurisdictions.

At a high level, these Principles represent the optimal states or targets for each regulatory system to achieve. Thus, where this report identifies gaps between any one regulatory system

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<sup>87</sup> Belgium, China, France, Germany, Hong Kong, Ireland, Italy, Japan, Ontario/Quebec, Poland, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

<sup>88</sup> Brazil, DIFC, Indonesia, South Africa and Turkey.

and these objectives, the Review Team recommends jurisdictions consider whether regime enhancements would strengthen the relevant frameworks. Importantly, however, not achieving a Fully Consistent rating in respect of any one Principle may not on its own undermine the overall quality or effectiveness of a jurisdiction's suitability framework. Indeed, a robust framework rated highly across other Principles may, in fact, offset isolated deficiencies with strengths in other areas.

Jurisdictions may wish to emulate certain of the examples and noteworthy practices highlighted throughout this report in connection with ongoing regulatory reforms. In addition to the participating jurisdictions, the Review Team encourages all IOSCO members to consider the relevant attributes of their regulatory frameworks alongside the analyses and conclusions explained throughout this report to inform their ongoing supervisory and policy agenda.

### *Programmatic Recommendations*

The Review Team recommends jurisdictions consider whether their suitability regimes address complex products, specifically, or are sufficiently sensitive to products of increasing complexity. Where jurisdictions apply bespoke requirements for complex products, they should establish clear criteria to aid intermediaries in distinguishing complex products from non-complex products.

As explained in the principle-by-principle analyses above, in some cases, the Review Team could not give 'Fully Consistent' ratings to jurisdictions that, while otherwise having strong requirements or protections, did not extend this framework to all of the relevant customer or product groups. Consequently, the Review Team encourages jurisdictions to consider the scope of existing requirements to ensure the sufficiency of their coverage.

### *Principle-Specific Recommendations*

In conducting this Review, the Review Team sought only to assess the consistency of each Participating Jurisdictions' efforts to the relevant Principles; the Review Team did not undertake to rate or rank those efforts in order to distinguish best practices. Consequently, while the Review Team could identify gaps between those regimes and the standards set by the Principles, the Review Team cannot espouse or offer recommendations on specific approaches to address those gaps. Instead, the Review Team wishes to draw attention to the following points, which relate to certain themes observed in different areas.

Principle 1, which addresses customer classification, proved to be the most difficult for jurisdictions to achieve 'Fully Consistent' rating. Most of the Participating Jurisdictions allow intermediaries to classify certain types of customers as 'non-retail' (or its equivalent) based on the nature of the entity or specified monetary thresholds alone. These practices do not consider the complexity and riskiness of different products, which is inherent to this Principle.<sup>89</sup> The

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<sup>89</sup> As addressed in Section 4.3.1, the Review Team observed that, where this is the case, most Participating Jurisdictions provided for consideration of product complexity and risks in connection with some, but not all types of customers.

Review Team recommends jurisdictions consider incorporating further consideration of product knowledge and experience into these classification decisions.

In relation to Principle 3, the Review Team encourages jurisdictions to consider enhancing disclosure requirements to ensure that customers have sufficient information upon which to base informed investment decisions and to understand the advice they receive from intermediaries. This Review shone light on practices such as providing information about the features of complex products to retail customers and requirements to provide customers with comparative information on less-complex alternative products.

In respect of Principle 5, the Review Team recommends that jurisdictions consider whether their regimes provide sufficient direction on the product due diligence element of the suitability assessment process.

Principle 9 relates to critical elements of any regulatory system. Jurisdictions must have effective supervisory and enforcement mechanisms to support suitability regimes for complex products. Put differently, without these tools, which incentivize compliance, the strongest or most thoughtful rules may be for naught. The Review Team recommends jurisdictions to make regular use of supervisory tools across all intermediaries that provide complex products and to ensure that intermediaries take corrective action where their behavior falls short of expectations.

## **ANNEX A – LIST OF PARTICIPATING JURISDICTIONS**

1. The Bahamas (Securities Commission of The Bahamas)
2. Belgium (Financial Services and Markets Authority)
3. Brazil (Comissão de Valores Mobiliários)
4. China (China Securities Regulatory Commission)
5. Dubai International Financial Centre (Dubai Financial Services Authority)
6. France (Autorité des marchés financiers)
7. Germany (Bundesanstalt für Finanzdienstleistungsaufsicht)
8. Hong Kong (Securities and Futures Commission)
9. Indonesia (Financial Services Authority)
10. Ireland (Central Bank of Ireland)
11. Italy (Commissione Nazionale per le Società e la Borsa)
12. Japan (Financial Services Agency)
13. Korea, Republic of (Financial Supervisory Service)
14. Morocco (Autorité Marocaine du Marché des Capitaux)
15. Ontario (Ontario Securities Commission) \*
16. Papua New Guinea (Securities Commission Papua New Guinea)
17. Poland (Financial Supervision Authority)
18. Portugal (Comissão do Mercado de Valores Mobiliários)
19. Quebec (Autorité des marchés financiers) \*
20. Russia (Central Bank of Russia)
21. Singapore (Monetary Authority of Singapore)
22. South Africa (Financial Sector Conduct Authority)
23. Spain (Comisión Nacional del Mercado de Valores)
24. Sweden (Finansinspektionen)
25. Switzerland (Swiss Financial Market Supervisory Authority)
26. Turkey (Capital Markets Board)
27. United Kingdom (Financial Conduct Authority)
28. United States of America (Securities and Exchange Commission\*\* and Financial Industry Regulatory Authority\*\*).

\* Joint response.

\*\* Joint response.

## **ANNEX B – ASSESSMENT METHODOLOGY AND QUESTIONNAIRE**

Available at: <https://www.iosco.org/library/pubdocs/pdf/Annex-B-Assessment-Methodology-and-Questionnaire.pdf>