



## OPINION

### **Structured Retail Products - Good practices for product governance arrangements**

#### **Legal basis**

1. Regulation (EU) No 1095/2010 (ESMA Regulation)<sup>1</sup> sets out the European Securities and Markets Authority's (ESMA) scope of action, tasks and powers which include “enhancing customer protection”, and “foster[ing] investor protection”.<sup>2</sup>
2. In order to continue delivering on this investor protection statutory objective, ESMA is issuing this opinion on certain aspects linked to the manufacturing and distribution of structured retail products (SRP). This opinion takes into account relevant work done in this field both at European and international level.<sup>3</sup>
3. This opinion is without prejudice to the requirements for the provision of investment services and activities established in the Markets in Financial Instruments Directive (MiFID)<sup>4</sup> and its implementing measures (notably, Directive 2006/73/EC), the regulatory developments arising from the MiFID review or existing product rules that may apply to SRPs.
4. ESMA's competence to deliver an opinion is based on Article 29(1) (a) of the ESMA Regulation. In accordance with Article 44(1) of the ESMA Regulation, the Board of Supervisors has adopted this opinion.

#### **Background**

5. In its July 2013 report on ‘Retailisation in the EU’<sup>5</sup>, ESMA highlighted that, from a consumer protection perspective, retail investors may face difficulties in understanding the drivers of risks and returns of structured products. If retail investors do not properly understand the risk and reward profile of structured products, and if the products are not properly assessed against the risk appetite of retail investors, retail investors might be exposed to unexpected losses and this might lead to complaints, rep-

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<sup>1</sup> Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010.

<sup>2</sup> See Articles 1(5) (f) and 8(1) (h) of the ESMA Regulation.

<sup>3</sup> Including, for example, (i) the Article 56 Joint Position of the European Supervisory Authorities on ‘Manufacturers’ Product Oversight & Governance Processes’ (Ref: JC-2013-77), published 28 November 2013; (ii) IOSCO Principles on Suitability Requirements with respect to the Distribution of Complex Financial Products (IOSCO FRO1/13, 21 January 2013); and (iii) IOSCO’s Consultation Report the Regulation of Retail Structured Products (IOSCO CR 05/13, 18 April 2013).

<sup>4</sup> Directive 2004/39/EC. The MiFID framework includes, inter alia, point-of-sale requirements, such as information, suitability, appropriateness, reporting obligations, and corresponding organisational requirements which are not dealt with in the context of this opinion and its annex.

<sup>5</sup> ESMA Economic Report ‘Retailisation in the EU’, No. 1, 2013 (Ref: ESMA/2013/326), published 3 July 2013.

utational risks for manufacturers and distributors, and a loss of confidence in the regulatory framework and, more broadly, in financial markets.

6. In 2013, ESMA mapped the measures adopted in the EU Member States in relation to complex products in order to identify issues and to better understand the rationale behind national initiatives (by looking at similarities and differences in the various approaches, and reviewing how complexity has been treated in the different EU Members States).
7. As a result, ESMA has developed a broad set of non-exhaustive examples of good practices, attached as Annex 1 hereto, illustrating arrangements that firms - taking into account the nature, scale and complexity of their business - could put in place to improve their ability to deliver on investor protection regarding, in particular, (i) the complexity of the SRPs they manufacture or distribute, (ii) the nature and range of the investment services and activities undertaken in the course of that business, and (iii) the type of investors they target. These good practices should also be a helpful tool for competent authorities in carrying out their supervisory action.

## **Opinion**

8. ESMA considers that sound product governance arrangements are fundamental for investor protection purposes, and can reduce the need for product intervention actions by competent authorities.
9. ESMA considers that, when supervising firms manufacturing or distributing an SRP, competent authorities should promote, in their supervisory approaches, the examples of good practices for firms set out in Annex 1 hereto.
10. Although the good practices set out in Annex 1 hereto focus on structured products sold to retail investors, ESMA considers that they may also be a relevant reference for other types of financial instruments (such as asset-backed securities, or contingent convertible bonds), as well as when financial instruments are being sold to professional clients.
11. The exposure to risk is an intrinsic feature of investment products. The good practices set out in Annex 1 refer to product governance arrangements and do not (and cannot) aim at removing investment risk from products.

## Annex 1

### Good practices regarding product governance arrangements for structured retail products

#### *Definitions*

1. For the purposes of these good practices:
  - a. ‘structured retail products’ (SRPs) are compound financial instruments that have the characteristic of combining a base instrument (such as a note, fund or deposit) with an embedded derivative(s) that provides economic exposure to reference assets, indices or portfolios. In this form, they provide investors, at predetermined times, with pay-offs that are linked to the performance of reference assets, indices or other economic values.<sup>6</sup>
  - b. ‘distribution’ is the provision of the investment service<sup>7</sup> of placement, reception and transmission of orders, execution of orders, portfolio management or of investment advice to retail investors (this definition also includes the case when, in the primary market, investment firms and credit institutions distribute their own SRPs).
  - c. a ‘distributor’ of SRPs is any natural or legal person that presents and/or sells an SRP to investors. In practice, within the supply chain for an SRP, the distributor is the last link: i.e. it is the firm that has the direct contact with investors, to whom it sells the SRPs issued either by itself (acting as a manufacturer and distributor) or by other firms (manufacturers).
  - d. to ‘manufacture’ an SRP is the process that begins with the product idea and ends with its final production stage.
  - e. a ‘manufacturer’ of SRPs is any natural or legal person that is responsible for the development and issuance<sup>8</sup> of an SRP or any natural or legal person that makes changes to, or combines, SRPs, provided that the natural or legal person is, for the purpose of its manufacturing activity, subject to regulation under Union sectoral legislation within the scope of action of ESMA. In practice, within the supply chain for an SRP, the manufacturer is the first link: i.e. it is the firm that creates and produces the SRP. A manufacturer often also ‘designs’, ‘originates’, ‘engineers’, ‘packages’ or ‘structures’ a product so that the distributor can sell it effectively.
  - f. ‘investors’ or ‘retail investors’ mean retail clients within the meaning of MiFID.<sup>9</sup>
  - g. ‘product governance arrangements’ or ‘product governance’ mean arrangements (such as policies, procedures, systems and controls) adopted by firms regarding the manufacturing and/or distribution of SRPs.

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<sup>6</sup> IOSCO, regulation of retail structured products, Consultation Report, April 2013, p. 6-7 (IOSCO CR 05/13, 18 April 2013).

<sup>7</sup> See MiFID, Annex I, Section A, (1), (2), (4), (5), (6) and (7).

<sup>8</sup> It should be noted that where the wrapper is a bond, its issuer may be a third party, which receives the ultimate cash and where the credit risk lies. However, for the purpose of this document, ESMA considers the role of such a third party issuer in the product governance arrangements to be a passive one and therefore we will not further address it in this opinion.

<sup>9</sup> Article 4(1) (12) of MiFID.

- h. ‘firm’ means an investment firm as defined in Article 4(1)(1) of MiFID, a credit institution when providing investment services as well as a UCITS management company and an external Alternative Investment Fund Managers (AIFMs) when they are providing the investment services of individual portfolio management or non-core services (within the meaning of Article 6(3)(a) and (b) of the UCITS Directive and Article 6(4)(a) and (b) of the AIFMD).
- i. ‘competent authority’ or ‘national competent authority’ means an authority designated by a Member State under Article 48 of MiFID, Article 97 of the UCITS Directive or Article 44 of the Alternative Investment Fund Managers Directive to carry out the duties provided under those Directives.

### *Product governance arrangements*

- 2. It is good practice for firms manufacturing and/or distributing SRPs to investors to adopt sound formal product governance arrangements. The arrangements should address from an early stage (in the manufacturing process, but also during the life of the product) any potential source of investor detriment and ensure that due consideration is given to the interest of investors during each stage of the life of an SRP (origination, launch, etc.).
- 3. It is good practice that, depending on their role (manufacturing and/or distributing), firms’ product governance arrangements cover the following areas:
  - a. general organisation of product governance arrangements;
  - b. product design;
  - c. product testing;
  - d. target market;
  - e. distribution strategy;
  - f. value at the date of issuance and transparency of costs;
  - g. secondary market and redemption;
  - h. review process.
- 4. Each of the above areas are described more fully below, and include details about when they are relevant for manufacturers and/or for distributors. A non-exhaustive list of questions is also proposed at the end of each section (shaded grey).<sup>10</sup>.
- 5. Although not involved in the manufacturing of an SRP, firms solely<sup>11</sup> distributing SRPs manufactured by third parties (distributors) hold a clear responsibility towards investors. According to MiFID, firms providing investment services have to act honestly, fairly and professionally in accordance with the

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<sup>10</sup> The questions are valid for both manufacturers and distributors, except when reference is made explicitly to ‘manufacturers’ or to ‘distributors’, rather than to ‘firms’.

<sup>11</sup> By solely, it is meant that the firm is not involved in any manner in the manufacturing of the SRP it distributes. For example, the SRP has not been originated according to the distributor’s instructions or description of needs of its clients.

best interests of their clients.<sup>12</sup> Furthermore, such firms also need to establish adequate policies and procedures to ensure compliance by the firm with its obligations under MiFID.<sup>13</sup> This means that it is good practice for distributors to ensure that they have a relevant understanding and knowledge of the financial instruments they propose for sale to their clients and define the relevant target clients for the SRPs they intend to distribute. This implies that product governance arrangements adopted by such firms are designed accordingly.

6. When a firm distributes an SRP manufactured by a firm which is not a MiFID firm<sup>14</sup>, it is good practice for that firm to take all reasonable measures to verify that the manufacturer of that SRP ensures a level of protection of investors' interests similar to the one promoted by the good practices included in this Annex.

### **General organisation of product governance arrangements**

7. Product governance arrangements should be transparent, consistent and auditable. It is good practice that key features of such arrangements set up by manufacturers or distributors:
  - a. define the steps that have to be followed before an SRP is to be manufactured and/or distributed, as well as describe the records that must be kept about all critical elements of the product governance arrangements;
  - b. define the roles, powers and responsibilities of the staff involved in the product governance arrangements;
  - c. ensure that the firm's senior management assumes responsibility<sup>15</sup> for the manufacture or distribution of SRPs;
  - d. ensure that the product governance arrangements do not rely excessively on the judgment and discretion of a limited number of individuals, but incorporates the effective input of all relevant staff;
  - e. ensure that the product governance arrangements are appropriately controlled, including involving among other functions such as compliance;
  - f. ensure that the product governance arrangements are reviewed and updated regularly, in order to ensure that they remain robust and fit for purpose (and therefore include all types of relevant business information analysis such as complaints or investor surveys), especially that they ensure that due consideration is given to investors' best interest.
8. It is good practice for manufacturers' product governance arrangements to define all interactions and, in particular, flows of information between them and their appointed distributor(s). Such flows of information include information to the manufacturer from the distributors about material complaints they have received regarding the SRPs previously sold.

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<sup>12</sup> Article 19(1) of the MiFID.

<sup>13</sup> Article 13(2) of MiFID.

<sup>14</sup> For example, it is not an investment firm authorised under the law of one of the EU Member States.

<sup>15</sup> 'Responsibility' is understood with regard to supervisory and not civil law purposes.

*Questions that could be considered regarding these good practices:*

- How do you ensure that an appropriate mix of individuals with decision-making powers is involved in the product governance arrangements and that those individuals don't intervene in conflicting roles (e.g. by avoiding overlapping membership on committees set up by the firm)?
- How are the skills of the staff involved in the process defined and assessed?
- Does relevant staff understand their role and responsibilities?
- Is independent staff<sup>16</sup> properly involved and empowered in the product governance arrangements? For each SRP manufactured and/or distributed, does a key decision function or committee take responsibility for the product governance arrangements within the firm?
- How are investors' interests taken into account? For example, what measures have you adopted to ensure that investors' interests are not compromised as a result of commercial, time or funding pressures?

## **Product design**

9. Notwithstanding the factors that manufacturers employ when designing<sup>17</sup> SRPs, it is good practice for manufacturers to ensure they meet the financial needs, investment objectives, knowledge and experience of the target market identified by the manufacturer. For example, the choice of underlying assets must be driven primarily by the demands of the potential target market and not for internal needs, e.g., to offload assets or liabilities from the manufacturer's own balance sheet or trading book.
10. It is good practice for the compliance function to be involved in the product design process and be entitled to intervene at every stage.
11. It is good practice for manufacturers to consider the best interests of the investor when designing, valuing and pricing the SRP. This implies for manufactures that they avoid conflicts of interests, e.g. non-competitive internal trading and/or hedging solutions. This also implies that they benchmark their intra-group transactions with third-party solutions to assure that such internal transactions are done at arm's length.<sup>18</sup> If other parties (including counterparties) are involved in the manufacture of an SRP, it is good practice for manufacturer to choose those other parties with care, i.e., to carry out appropriate and reasonable due diligence to manage operational risk linked to the selection of those parties.
12. It is good practice for manufacturers to use modeling and statistical test analysis when designing SRPs. This implies that, prior to issuance, manufactures conduct robust, unbiased and arbitrage-free testing so as to allow for an external party to adequately challenge the SRP's pricing, valuation, and risk/reward trade-off relative to the target market.

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<sup>16</sup> For example, in the risk, audit and or compliance functions.

<sup>17</sup> Such sources can include own trading or propriety exposures, inquiries from investors or third-parties, feedback from the sales force, analysis of SRPs distributed by competitors, investment 'themes' or market trends.

<sup>18</sup> This could be done for example by conducting a tender process amongst several counterparties before deciding on which counterparty to use or determining the value of a specific component of the SRP (as is done often with a CDO square when determining the value of a CDS).

13. It is good practice for manufacturers to ensure that appropriate information is made available to distributors concerning the SRPs they manufacture.
14. SRPs can involve complex financial engineering. It is good practice for firms to ensure that SRPs' key features are visible for distributors and retail investors. This implies making clear the pay-off design and the expected returns and risks, including the potential for partial or full loss of invested capital.

*Questions that could be considered regarding these good practices:*

- Do the manufacturer's systems and controls sufficiently support the SRP production process or will new IT systems and applications be needed?

### **Product testing**

15. It is good practice for manufacturers to consider the characteristics (especially the risk characteristics) of the SRP (such as illiquidity and riskiness of the underlying asset(s)) and to have an understanding of the model and input parameters as well as the assumptions built into the valuation of the SRP (e.g. the expected returns, the pay-off structure, its fair value).
16. It is good practice for manufacturers to back test the SRP to understand how it would have performed in the past. It is good practice for manufacturers to undertake simulations of future performance scenarios to assess whether likely outcomes of the SRP would meet the investment objectives of the target market. Product testing assumptions are objective and enable manufacturers to assess whether the risk/reward trade-off of the SRP is *fair* for its target market. Such assessments take into account all relevant fees and costs (including implicit premiums or mark-ups and explicit fees on top of the intrinsic value) in order to verify how these fees and costs affect investors' final expected return.
17. It is good practice for tests to be done in an independent manner (i.e. apart from the trading or hedging unit) and for manufacturers to keep an audit trail of the results of the testing. Those results should be available on request to competent authorities. Testing should include model and operational risks. Risk management methods used by a firm when manufacturing an SRP should be consistent with the firm's internal risk management framework. It is good practice for testing to also consider extreme economic environments ('stress testing')<sup>19</sup> and include quantitative assessments of external (primarily financial) risks.
18. It is good practice for distributors to ensure they are aware and understand the results of such tests as well as the simulations of performance scenarios undertaken by the manufacturer. This implies that distributors at a minimum adopt adequate arrangements to examine critically those results and scenarios and, if needed, employ an independent third-party with the relevant expertise. It is therefore good practice for manufacturers to make the results of those tests and the scenarios available to the distributors.

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<sup>19</sup> e.g. SRP's performance tests under various market conditions (stressed markets, including interest rates spikes and, where applicable, currency risks, etc.).

*Questions that could be considered regarding these good practices:*

- How do the results of the product testing affect the way the SRP is offered to investors? For example, if the testing suggests that the SRP is statistically unlikely to deliver market returns, how are such pay-out scenarios disclosed in a fair and non-misleading manner?
- If the testing suggests that the SRP is statistically likely to deliver lower or negative returns, how are such pay-out scenarios disclosed?
- How do the results of the testing affect the design of the SRP under consideration and of future SRPs in general? Is the best interest of the investor considered at each stage?
- Has the manufacturer and/or distributor defined performance thresholds that triggers a freeze in the development or distribution of the SRP?
- What are the assumptions that underlie the SRP design and how sound are they? Is the underlying asset of the SRP appropriate, taking into account the needs, objectives and characteristics of the potential target market?
- Do the product governance arrangements allow for periodic review of the SRP or are its conditions fixed at the outset?

**Target market**

19. It is good practice for manufacturers to identify appropriately the potential target market for the SRPs they plan to issue.
20. It is good practice for distributors to appropriately identify and analyse the target market for each SRP they intend to distribute. Furthermore, good practice implies for distributors that they establish how (in the context of the provision of which type of investment service) and to whom (which types of clients) they will distribute the SRP. The analysis of the target market for the purposes of product governance arrangements is distinct from the MiFID suitability or appropriateness requirements: both cover different dimensions and the identification of the target market for an SRP does not replace the mandatory assessment by the firm acting as a distributor of the suitability or appropriateness of a given SRP for a given individual investor.
21. When assessing which investors are most appropriate to invest to the SRP to be manufactured or distributed, it is good practice for firms to consider different criteria, such as:
  - a. To which market does this SRP provide exposure?
  - b. What is the needed investment horizon of a prospective investor to this SRP?
22. Distributors will be able to make a more detailed and refined target market assessment once they have specific client information. On the basis of their experience with investors they can discuss with the manufacturer the exact needs of the target market.
23. When determining the target market for an SRP, it is good practice that firms take into account the potential 'limits' of secondary markets for SRPs that are not listed on a liquid regulated market: This



implies that SRPs are only targeted to those investors for which the characteristics of the SRP in terms of liquidity and holding period are suitable.

24. Firms should understand in sufficient detail the target market for the SRPs they manufacture and/or distribute. It is good practice for firms to conduct robust research to understand investor needs, objectives and ability to understand the SRP so as to enable firms to reject inadequate SRPs targeting a market segment before they are launched. It is good practice for firms to analyse the charging structure of the SRP before manufacturing or distributing, i.e., to assess whether a less complex, costly or risky product could meet the demands and investment objectives of the target market identified.
25. An understanding of the target market is particularly relevant for the following reasons:
  - a. choosing the appropriate way to distribute the SRP;<sup>20</sup>
  - b. advertising the SRP to potential investors;
  - c. avoiding any form of exploitation of investor behavioral biases;
  - d. overcoming information discrepancies by providing, at minimum in the marketing materials, sufficiently detailed information on the results of the scenario analysis (three financial market scenarios should be used: performs well, offers no return and performs poorly - including where a counterparty involved in the product fails); and
  - e. constructing a policy as to the appropriate action(s) to be undertaken if a material change occurs that affects an SRP, or if an SRP fails to function as investors had been led to expect.

*Questions that could be considered regarding these good practices:*

- What measures has the distributor adopted to reasonably ensure that investors of the SRP target have sufficient knowledge and experience to understand the SRP's structure, and payoff function in order to be able to make an informed investment decision?
- Does the SRP meet the demands and investment objectives of the target market identified by the distributor?
- Does the distributor know whether the target market can absorb the risk of any capital loss identified in its product analysis? What is the likely financial situation (e.g., high/low income, short/long term horizon, etc.) of the target market? Are there any investment limits foreseen (e.g. a maximum percentage to be invested in the SRP relative to the investor's global net worth)?
- Based on the analysis carried out by the distributor, what should be the investment horizon of the SRP's target market?
- Is the SRP intended for general retail distribution or for a more limited market?<sup>21</sup>

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<sup>20</sup> Distribution here should be understood widely and includes:

- for manufacturers, types of distributors through which the manufacturer is going to distribute the SRPs it has manufactured;
- for distributors, how (in the context of the provision of which type of investment service) and to who (which types of clients) it is going to distribute the SRP.

- What is the expected issuance size for the SRP?

### **Distribution strategy**

26. It is good practice for manufacturers and distributors to put investors' best interest first in their distribution strategy. This implies taking appropriately into account potential risks arising from the way they distribute (directly or indirectly) SRPs.
27. It is good practice for manufacturers distributing their SRPs through other firms to adopt appropriate policies and procedures regarding their relationships with those firms. Such policies and procedures should at minimum cover the following:
  - a. criteria and procedures governing the choice of those firms;<sup>22</sup>
  - b. roles and responsibilities of the different parties;
  - c. provision to distributors of sufficiently detailed information about the SRP's pay-off structure, the model, valuation methods and SRP risk/return scenarios;
  - d. assist distributors in identifying conditions when the SRP should not be distributed to an identified target market;
  - e. flagging key risks and returns (including expected pay-off function).
28. It is good practice that distributors require sufficient information including from manufacturers, in order to be able to adequately train their staff. This includes information as to the need for the distributor to provide investment advice in relevant situations (particular care with the use of non-advised sales should be taken if an SRP has features which are difficult to explain to investors). It is good practice for distributors not to merely rely on the information provided by the manufacturer, but to conduct their own analysis of the SRP.
29. When reviewing information provided by manufacturers, it is good practice for distributors:
  - a. to consider, when providing manufacturers' materials to clients, whether they understand the information included;
  - b. to ask the manufacturer to supply additional information or training where that seems necessary to understand the SRP adequately; and
  - c. not to distribute the SRP if it does not understand it sufficiently, especially if it intends to provide investment advice.
30. It is good practice for distributors to consider the unique risk factors of the SRP when monitoring the distribution strategy.

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<sup>21</sup> For example, is the SRP only directed towards investors in private banking or those with a given risk profile?

<sup>22</sup> An appropriate due diligence should be done especially to avoid operational, counterparty and reputational risks. That due diligence should at least be made using information publicly available and includes assessing the financial capability of the firm distributing the SRP and its fulfilment of legal and regulatory responsibilities.

31. It is good practice for manufacturers and distributors:
- a. to determine necessary training, support and relevant disclosures needed based on the nature and complexity of the SRP to be distributed;
  - b. to ensure that the primary purpose of training is educational and not to be used as a marketing tool. The content of training presentations should be sufficient, appropriate and comprehensible and should not diminish the risks of a particular SRP.
  - c. to ensure compliance with the MiFID remuneration guidelines.<sup>23</sup>

*Questions that could be considered regarding these good practices:*

- How do you, as a manufacturer or distributor, define your distribution strategy for an SRP, given the characteristics of the target market? Do you regularly re-assess your distribution strategy and what measures do you adopt if your strategy does not work as planned?
- As a manufacturer, have you identified and informed firms you use to distribute an SRP about the types of investors to which the SRP should not be distributed?
- As a manufacturer, do you distribute through other firms' SRPs that you would not distribute directly to investors? Why?
- As a manufacturer what happens if sales levels are substantially different than expected relative to trading positions and hedging strategies? Is there a position management policy for different scenarios (unwinding or increasing of the trading position in case of favorable or unfavorable market conditions)? Which entity of the firm assumes additional gains or losses? What are the implications to investors? Do you request an explanation from the distributor(s) for such differences?

### **Value at the date of issuance and transparency on costs**

32. It is good practice for manufacturers to establish and make available, directly or indirectly, to retail investors the value (at the date of issuance) of the SRPs they manufacture. It is good practice for the value to be determined consistently with modeling and statistical analysis implemented for the product design and testing as well as with the methodologies, modeling and standards used by the manufacturer to value its own proprietary portfolio. It is good practice for this value to reflect the value at which that SRP and/or its components are, where relevant, valued in the manufacturer's accounts.
33. It is good practice for the value to be established by using standards generally recognised and accepted in the market. For example, the value of the SRP could be established according to IFRS 13, which refers to the concept of "fair value" which is defined as "*the price that would be received to sell an asset or to transfer a liability in an orderly transaction between market participants at the measurement date*".<sup>24</sup> This notion of *fair value* or *exit price* is based on the assumption that the elements to be measured are done so in their highest and best use (i.e. the use that would be made by a market participant acting in its economic best interest provided it is physically possible, legally permissible, and

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<sup>23</sup> Reference is made here to the following document published by ESMA: Guidelines on remuneration, final report, ES-MA/2013/606, 11 June 2013.

<sup>24</sup> All entities which publish their accounts under IFRS are concerned by IFRS 13 "Fair Value measurement" and mandatory to report accordingly as of 1 January 2013.

financially feasible). Under IFRS 13 transaction costs are considered as entity specific and are excluded in determining the fair value of an asset. Another option would be to use the concept of “intrinsic value”: the value of the SRP should sum up separately to the value of each of its components (e.g. the known or estimated costs and fees, the embedded derivative and its base component), including estimated costs and fees, while reflecting the market and pricing conditions at the moment when the value is communicated to investors.

34. It is good practice that, before distributing an SRP, distributors examine critically whether the SRP is in the best interest of its clients and verify its value (if necessary with the assistance of a qualified third-party).

*Questions that could be considered regarding these good practices:*

- Would a professional client buy the SRP at the price at which it is being offered to retail investors? How can differences be explained?
- Are all cost and price calculation principles clear and transparent? What costs and fees for the retail investor are associated with the SRP?<sup>25</sup> Are harmonised cost measures used?<sup>26</sup> Are all charges and fees transparent to the investor?
- How are the reported values established?<sup>27</sup> Are you employing same pricing model and valuation techniques as at the time of the original pricing when the terms of the SRP were fixed? If not, why?

### **Secondary market<sup>28</sup> and redemption**

35. SRPs are often designed for ‘buy and hold’ investment strategies and in turn should be targeted to investors whose investment horizon is consistent with the term of the SRP.<sup>29</sup> When SRPs are not listed on a liquid secondary market, it is good practice for firms to offer exit opportunities to investors who may need to sell the SRP before its end term and disclose those opportunities appropriately to the investor.
36. It is good practice for ‘exit prices’ of non-listed SRPs (i.e. the price at which the investor may sell its SRP before its final term) to be determined using objective and predefined methodologies of which investors should be informed in advance.
37. When a secondary market (other than a regulated market) exists for the SRPs distributed, it is good practice for firms to adopt policies and procedures identifying and managing all relevant risks linked to trading on that secondary market.

<sup>25</sup> Including implicit premiums or mark-ups.

<sup>26</sup> E.g. such as the total expense ratio or total cost of ownership.

<sup>27</sup> E.g. mid evaluations, closing prices, (own) credit risk.

<sup>28</sup> Once the initial offering (initial inscription period, initial sale or primary market) of an SRP is closed, the secondary market starts which typically runs until the final maturity of the particular SRP. Contrary to plain vanilla products where secondary markets usually provide an avenue for resale, secondary markets in SRPs present monopolistic characteristics which can lead to a variety of economic performance problems (such as barriers to enter or exit and price and quality issues due to information difficulties creating potential conflicts of interest and lack of liquidity).

<sup>29</sup> When determining the target market for an SRP, firms need to take into account the ‘limits’ of secondary markets for SRPs: SRPs can only be targeted to those investors for which the characteristics of the SRP in terms of liquidity and holding period are suitable. [this is not secondary market issue].

38. When the SRP trades on the secondary market (other than a regulated market), it is good practice for the distributor<sup>30</sup> to disclose appropriately and in due time:
  - a. the conditions of trading on the secondary market;<sup>31</sup>
  - b. the methods used to determine the secondary market price of the SRP;
  - c. the means used to inform investors about the secondary market price of the SRP they hold; and
  - d. possible costs associated with the clients' market transactions and with the making of the secondary market.
39. It is good practice for firms to also provide appropriate information on costs associated with redemption from the SRP. Such information details redemption fees payable on exit and any deferred sales charges owed due to redemption from the SRP. Such information also includes transparency as to any pre-payment penalties owed due to redemption from the SRP prior to the contractual maturity.
40. It is good practice for firms to ensure they are ready to explain to its investors the reasons for the differences between reported valuations and actual traded prices.
41. It is good practice for manufacturers to adopt appropriate measures and set up necessary controls to guarantee, at the maturity of the SRP, the accuracy of the final pay off calculations. It is good practice for distributors to monitor and examine critically the results of those final calculations.
42. It is good practice for firms to announce the repayment due in a timely manner to investors.<sup>32</sup> Investors are entitled to receive, on request, a detailed explanation about the payoff calculation mechanisms and the value of the underlying at the due date. Such information should also be available to competent authorities on request. It is good practice for firms to ensure investors are repaid the due return from their investment promptly, avoiding any delays.
43. It is good practice for firms to provide sufficient timely information to investors to enable them to consider in advance the different reinvestment options offered to them.<sup>33,34</sup> It is good practice for the terms governing reinvestment options prior to or on SRP maturity to be subject to an explicit agreement between the investor and issuer/distributor.

*Questions that could be considered regarding these good practices:*

- Do you organise a secondary market for the SRPs you manufacture or distribute? If not, why? What are the options offered to investors who seek to redeem the SRP?<sup>35</sup>

<sup>30</sup> In practice, such information should be provided by the distributor to its clients, using if and when necessary information it has obtained from the manufacturer. The distributor should ensure it can have access to such information.

<sup>31</sup> E.g. inform on eventual costs and/or exit penalties, bid/offer spreads, minimum volumes, frequency of transactions.

<sup>32</sup> In practice, such information should be provided by the distributor to its clients, using if and when necessary information it has obtained from the manufacturer. The distributor should ensure it can have access to such information.

<sup>33</sup> In practice, such information should be provided by the distributor to its clients, using if and when necessary information it has obtained from the manufacturer. The distributor should ensure it can have access to such information.

<sup>34</sup> E.g. to remain invested in a similar newly manufactured SRP, to invest in another SRP or to recover the investment capital at maturity.

<sup>35</sup> E.g. unemployment, payment difficulties, illness, death.

- What criteria were employed for the product governance arrangements to allow the manufacture or the distribution of an SRP, in the absence of any exit opportunities for the investor? How will the conflict be resolved in the interests of the investor?<sup>36</sup>
- If a third party supplied the derivative leg of the SRP, does the contract include a clause with respect to secondary market trading (e.g. unwinding conditions)?

### Review process

44. At the close of the initial offering of an SRP,<sup>37</sup> it is good practice for manufacturers to periodically gather appropriate information as to the performance of the SRP.<sup>38</sup> This is to improve the design and manufacture of SRPs in development, to better frame the SRPs to the needs of the target market and to improve the firm's product governance arrangements.
45. If there is a significant difference between the actual and expected performance of the SRP, it is good practice for firms to have in place robust systems and controls that enable them to understand the differences and, where necessary, to review their product governance arrangements. It is also good practice for firms to consider what appropriate action(s) could be taken to mitigate detriment to investors when an existing SRP does not perform as expected.<sup>39</sup>

#### *Questions that could be considered regarding these good practices:*

- Do you gather relevant and sufficient management information to monitor performance – such as sales data, the level of cancellations, early redemptions – to check if the SRP distributed is reaching the target market and to test target market's experience with the SRP?
- If the sales are higher than expected, do you investigate the reasons for this (for example, are hard selling techniques being used or is the SRP being distributed not only to the target market)? What measures do you adopt in such circumstances?
- Are some distribution strategies (e.g., distribution channels chosen by the manufacturer or the way(s) distributors distribute SRPs) better or worse than others?
- Have there been any changes to wider factors – such as the market, legislation, counterparties or the firm itself – that may affect the SRP's performance?
- Do you have a procedure for ceasing to distribute the SRP if its performance falls below a certain threshold?

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<sup>36</sup> E.g. improved product conditions or limitation of invested capital.

<sup>37</sup> E.g. initial inscription period, initial sale, launch or primary market.

<sup>38</sup> E.g. if it continues to meet the needs of its target market, if its performance is significantly different from the one advertised or if the SRP meets the initial success criteria.

<sup>39</sup> Joint Committee Consultation Paper on draft guidelines for complaints-handling for the securities (ESMA) and banking (EBA) sectors (JC/CP/2013/03).