

Retail Structured Products: Draft principles for managing the provider-distributor relationship

A. Background to the Principles

The draft principles set out below seek to address issues that firms have in practice found it helpful to consider when contributing in any role to the process of delivering structured products to retail investors. It should be noted that **the principles are non-binding and, as such, intended purely to help inform firms' thinking.**

The principles are the product of a working group of firms, taking in the views of distributors and providers and supported by a coalition of trade associations: European Securitisation Forum (ESF), International Capital Market Association (ICMA), International Swaps and Derivatives Association (ISDA), London Investment Banking Association (LIBA) and Securities Industry and Financial Markets Association (SIFMA).

Structured products include a variety of financial instruments that combine various cash assets and/or derivatives to provide a particular risk-reward profile that would not otherwise be available in the market. The exact risk-reward profile varies from instrument to instrument.

The precise arrangements between the parties and the fact that structured products combine various components may in practice result in different parties being responsible for different aspects of the related regulatory obligations. These principles particularly focus on how to address this issue, given that all parties have a common interest in customers obtaining satisfaction with regards to their legitimate expectations as to performance of the investment.

The principles are drafted with no single jurisdiction in mind. They are, on the contrary, intended for global application. The specific (and possibly more detailed) procedures that any firm might in practice adopt to help it manage provider-distributor relationships with regards to retail structured products will be a function of factors such as the jurisdiction or jurisdictions involved, the precise nature of the products and the nature of the relationship between the parties.

The principles are drafted for comment by all interested parties within the next [6] weeks, ie, by close on Wednesday, 30th May 2007. Please submit any comments to the trade association staff person that provided you with this draft, or to any of the trade associations listed, copying if possible Richard Metcalfe (rmetcalfe@isda.org).

B. Draft Principles

1. Distribution to the retail purchaser of structured products is generally through intermediaries, such as private banks, rather than directly by the product 'provider' (sometimes referred to as 'manufacturer').
2. Where a product provider and a private bank (or other retail-facing business) operate within the same institution, they will generally operate distinctly; be subject to different regulation; and have different reporting and management structures. This separation is generally robust and will be driven by legal, compliance, confidentiality and other requirements. Thus even where a product is originated and distributed by the same institution, there will usually be a separation between the manufacturing and distribution functions to which these principles should apply.
3. Product providers should have formal internal approval processes for retail structured products; such processes should address both product structuring and distribution issues.
4. The distribution structure means that it is the distributor who interfaces with the investor and whose client that investor is. Investor suitability is exclusively an issue for distributors, since it must be considered in the context of confidential information provided by the client to the distributor
5. Distributors must understand the products they distribute. Where distributors provide term-sheets or other material to their clients, those materials are their materials, even if they incorporate material provided by the product provider; this means that a distributor must be satisfied with and take responsibility for the accuracy and the compliance of such materials with local law and regulation.
6. Product providers should ensure that their term-sheets and other materials are accurate, and clear, and that they are presented in a way which is consistent with their agreed obligations to the distributor. For example, where the parties understand that the product will be distributed by the distributor to high net worth individuals, the termsheet should not contain rubric that the product is not suitable for individual investors. Providers should assist the distributor by providing information which is clear and of the kind requested by the distributor in preparing its own termsheet or product description for its client. This may include scenario analyses and relevant to product risk factors.
7. When commencing dealings with a distributor, product providers should consider whether the distributor is an appropriate distributor for the placing of particular types of products and, where they consider it necessary, practical and appropriate to do so, should conduct a "know your distributor" approval process. There is no fixed form for this process, which can vary according to the circumstances, and there are a number of means by which a provider can gain comfort as to the integrity of a distributor's processes. Issues which may typically be considered would include a distributor's typical client type, suitability determination processes, reputation and compliance with selling laws, but this will vary widely depending on the distribution, the particular product and the relevant jurisdiction or jurisdictions. Each party does, in any case, retain its own regulatory obligations; no party takes on the regulatory obligations of another.

8. Product providers and distributors should seek to agree and record their respective roles and responsibilities towards investors.

9 Law and regulation may not distinguish sufficiently between product providers and distributors, and this may create uncertainty as to where legal or regulatory liabilities may fall. (An example is Article 3(2) of the EU Prospectus Directive.) This uncertainty may arise for the provider through the distributor's choice of distribution methods, or for the distributor through actions of the provider or through the provider's dealings with other distributors, and may persist even where all concerned have complied to the best of their knowledge and ability with relevant selling laws and conduct of business rules. Providers and distributors should be aware of this uncertainty and its consequences.

10. Distributors should also evaluate product provider counterparties ("know your product provider"), particularly as regards the product provider's performance with respect to those items mentioned in 6 above.