FSMA

FINANCIAL SERVICES AND MARKETS AUTHORITY

Communication

Communication FSMA 2011_02 of 20/06/2011

MORATORIUM ON THE DISTRIBUTION OF PARTICULARLY COMPLEX STRUCTURED PRODUCTS

updated version of 26 September 2011

Scope:

The moratorium applies to the distribution to retail investors of structured products that are considered particularly complex.

Summary/Objective:

The FSMA calls upon the financial sector not to distribute to retail investors structured products that are considered particularly complex. Distributors that sign on to the voluntary moratorium commit themselves not to distribute structured products that do not meet the criteria that have been established. Participating distributors will be placed on a list kept by the FSMA. The voluntary moratorium remains in effect until new rules on the distribution of structured products to retail investors have been drawn up. This voluntary moratorium is a first step in a process that is intended to lead to a more transparent and simpler product offer.

Structure:

The Communication consists of two parts. The first part sets out the general framework in which the voluntary moratorium must be situated. The second part describes the modalities and the criteria of the moratorium.

Dear Sir or Madam,

I. General framework

1. Increasing the traceability of financial products

In the light of the financial crisis, the Special Committee of the Belgian Parliament tasked with investigating the financial and banking crisis recommended, in its report of 27 April 2009, that the traceability of financial products be improved. The FSMA has, in fact, made a strong case in favour of such a measure.

By means of the Law of 2 July 2010, the Parliament conferred upon the FSMA the competence to issue regulations that may impose a ban or restrictive conditions on trading in retail investment products, or that may enhance transparency in the pricing and administrative costs of such products[1].

From the preparatory work, it became clear that it should be possible to impose restrictive conditions on certain products, particularly where their *complexity* renders them unsuited to the average retail investor. The preparatory work also indicated that *transparency requirements* may be imposed as regards pricing and cost structure, given that the aim is to draw up rules that are the same for all instruments and products.

2. Why the market in structured investment products?

Given the scope of this market, the FSMA wishes, as a first step, to focus on the market in structured products for retail investors. With a total outstanding amount of around 85 billion euros in 2010, the Belgian market constitutes one of the largest in Europe. By way of comparison, at the end of 2010 there were in Belgium around 200 billion euros held in regulated savings deposits and around 35 billion euros in term deposits.

Structured products are complex investment products. They are generally made up of a savings component, such as a zero-coupon bond, and one or more derivatives. The derivative component can be very complex in structure, with the yield depending on a great many mechanisms. This does not make it easy to evaluate and monitor the performance of the product.

It is very important that the interest of the customer be at the forefront, from the development of a product to its distribution and subsequent monitoring, and that the consumer be informed with complete transparency. Transparency can apply to the individual components, to the costs that are included in or charged over and above the subscription price, to the expected value and the risks incurred, to the strategy and the underlying, and to the performance of the product after its distribution.

The approach taken by the FSMA builds on the lessons learned from the financial crisis. It is a future-oriented and preventive approach that intervenes not only with regard to transparency or rules of conduct, but also in the production process itself.

The FSMA's approach is part of a tendency that has also been observed in other countries[2].

In order to create a level playing field for all structured products, the FSMA does not make any distinction, in its intervention, on the basis of the packaging of the structured product in question, be that as a UCI, an investment instrument, a class 23 insurance contract or a deposit.

---

1 The FSMA can exercise this competence upon the advice of its Supervisory Board and of the Consumer Board (Conseil de la Consommation/Raad voor het Verbruik), and should do so taking into account the interests of consumers of financial services.

2 See in particular the United Kingdom (FSA "Discussion Paper 11/1 Product intervention"), France (position of the AMF dated 15 October 2010 concerning the distribution of complex financial instruments), Italy (CONSOB notice no. 9019104 of 2 March 2009 on "the intermediary's duty of correct and transparent conduct in the distribution of illiquid financial products"), the United States ("investor alert" by the SEC and FINRA of 2 June 2011 on structured notes with principal protection) and Denmark ("Executive Order no. 345 dated 15 April 2011 on risk-labelling of investment products").

The FSMA is also examining the possibility of taking action in respect of other financial products in order to protect the interests of consumers.

3. A three-step process

The voluntary moratorium on particularly complex structured products constitutes the first step in a process intended to increase the traceability of retail investment products.

The second step will be a public consultation to be held by the FSMA. This will allow all interested parties to express their views on a new regime for the distribution of structured products to retail investors. The consultation is expected to start before the summer recess.

Based on the results of the consultation, the FSMA will, in the third step, draw up a regulation promulgating the new regime.

By means of this three-step process, the FSMA wishes to simplify the market and render it more transparent, regardless of the form of the product being distributed. This can help consumers to gain greater insight into the choices facing them, enhance the comparability of the various products and foster competition. Confidence in financial institutions and the smooth operation of the financial markets will be strengthened as a result.

During the voluntary moratorium, distributors of structured products are asked to commit themselves not to distribute to retail investors any structured products that are considered "particularly complex" on the basis of criteria set out by the FSMA. This request is motivated by the need for some restraint during the period of the consultation and the preparation of the Regulation. Doing so should make possible a serene discussion of the new regime that is to govern the distribution of structured products to retail investors. The moratorium has no impact on the assessment of compliance with the regulatory framework governing the relationship between the distributor and the consumer for products that were distributed in the past.

The FSMA notes, finally, that the moratorium applies to certain structured products regardless of the inherent risk of the product in question. The fact that a product is not considered particularly complex does not in any way imply that it is risk-free.

II. Criteria for the moratorium

The moratorium applies to the distribution to retail investors, by the distributor, of structured products that are considered particularly complex.

1. "the distribution"

By "distribution" we mean: "offering a product in a variety of ways (advertising, direct sales, placement, advice, etc.)[3] in order to urge the customer to accept it".

2. "by the distributor"

By "distributor" we mean: "any credit institution, investment firm, insurance company, intermediary in banking and investment services, insurance intermediary or management company of an undertaking for collective investment that distributes structured products to retail investors". The call for voluntary participation in the moratorium is also directed to issuing institutions that distribute the products themselves.

If a distributor voluntarily signs on to the moratorium, the commitment applies to all structured products that he distributes, regardless of legal form. If a group consists of different distribution channels (bank, insurance, asset management) that are active in Belgium, participation in the moratorium must apply to all distribution channels within the group, in order to avoid confusion on the part of the public.

The distributor may opt not to apply the moratorium to retail investors who hold deposits and financial instruments with the distributor with a value, at the time of distribution, of more than EUR 500,000. This opt-out applies only to the part of the asset that exceeds EUR 500,000. The opt-out does not detract from the existing regulatory framework.

Under the opt-out, products can only be distributed to the aforementioned retail investors if the marketing materials are directed only to the said retail investors and if the following sentence appears clearly on the marketing materials and on the subscription form: "this structured product qualifies as particularly complex for retail investors under the terms of the moratorium by the FSMA on the distribution of particularly complex structured products".

3. "of structured products"

By *structured products* we mean: an investment product (investment instrument, unit issued by a UCI, insurance contract or deposit) that includes a derivative component and the repayment or yield of which, calculated by means of a formula, depends on the performance of one or more underlyings.

This definition covers, among other things:

- products that are indexed to baskets of shares;
- products whose derivative component is index-linked;
- autocallable products;
- reverse convertibles on shares or indexes.

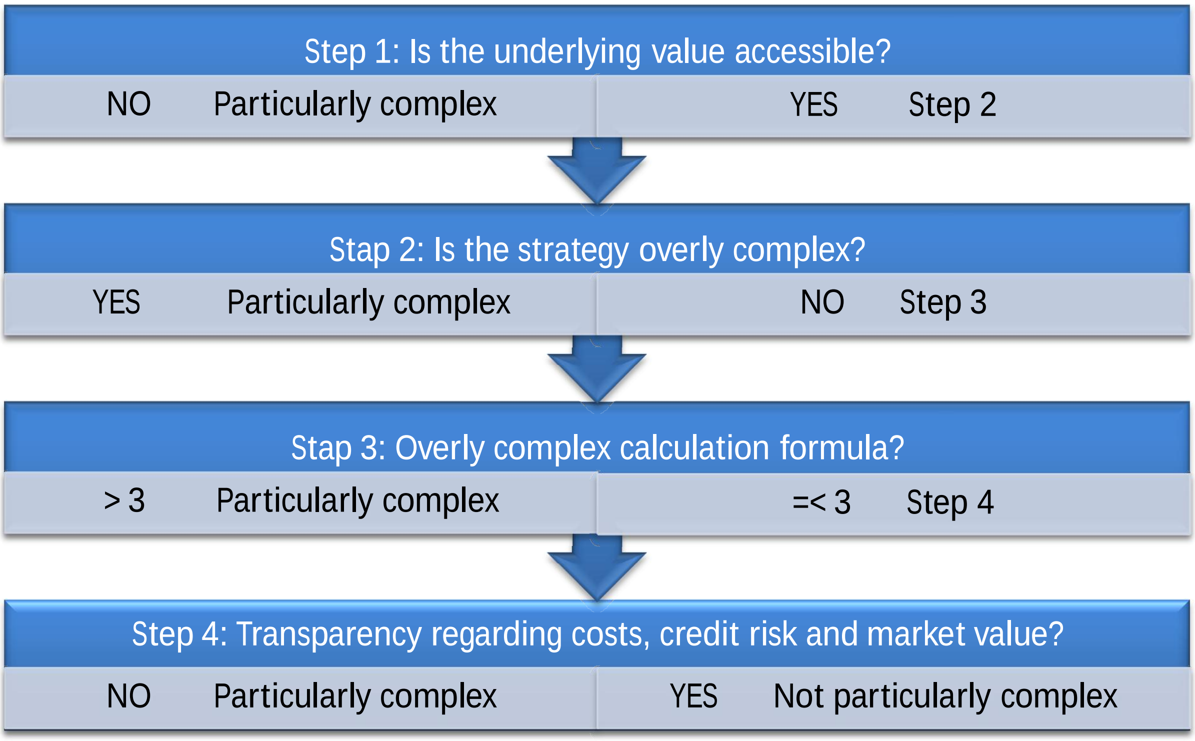
3 Discretionary portfolio management lies outside the scope of the moratorium, given that discretionary portfolio management does not involve distribution within the meaning of point 1.

The following products , for example, do not qualify under this definition as structured products:

- shares;
- bonds, whether subordinated or not, convertible bonds and bonds with warrant;
- collectively managed products of which the underlying portfolio does not consist of a derivative component and (generally) a savings component[4];
- class 21 insurance contracts;
- term deposits, insofar as the yield does not depend on the performance of an underlying;
- certificates of deposit;
- real estate certificates.

4. "that are considered particularly complex"

For the purposes of the moratorium, a structured product is considered particularly complex for retail investors if it does not pass the test of the following four criteria. If one of these criteria is not met, the product is considered particularly complex.



4.1. When is the underlying of the derivative component considered accessible?

4 These products can take the form, for instance, of a UCI, a class 23 insurance contract, a pension saving fund or a pension insurance contract.

For the purposes of the moratorium, the underlying is considered accessible if the retail investor can observe the relevant market data or the specific characteristics of the (combination of) underlyings by means of the customary channels (internet, printed press). This applies, among other things, to the following underlyings:

- investment instruments admitted to a regulated market or, outside the European Union, to an equivalent market;
- securities indexes that have sufficient renown, track record and transparency and that serve as benchmarks (e.g. BEL 20, CAC 40, DJ Eurostoxx 50);
- UCIs that are entered on the lists referred to in Articles 31 and 129 of the Law of 20 July 2004, or UCITS;
- interest rates;
- the inflation index;
- the exchange rate of a currency.

A customized selection of individual shares or a customized index can also be considered accessible for the application of the moratorium where (cumulative conditions):

- the selection or the customized index is sufficiently diversified[5];
- the selection or the customized index is based on economic foundations and is in the interest of the customer;
- the marketing material used in distribution provides information on the composition and the economic foundations of the selection and, for customized indexes, on the composition, investment policy and frequency of rebalancing, and
- throughout the lifetime of the product, the website of the distributor[6] contains information on the composition of the selection or of the customized index, either whenever there is a change in one of the shares among the selection, or at least every three months in the case of a customized index.

The following, among others, are <u>not</u> considered accessible for purposes of the moratorium:

- credit default swaps;
- indexes or customized selections of shares that do not meet the aforementioned criteria;
- commodities (commodity indexes) other than gold;
- aleatory contracts, such as life settlements;
- investment instruments not admitted to a regulated market or, outside the European Union, to an equivalent market, other than the aforementioned units in undertakings for collective investment;

5 Cf. the requirements included in Articles 34ff of the Royal Decree of 4 March 2005. This means, specifically, that at least 16 shares must be included.

6 If the distributor does not have a website, the information may be published on the issuer's website.

- assets that are not eligible for direct distribution in Belgium, such as hedge funds.

Distributors who sign on to the moratorium and who wish to distribute a structured product whose underlying does not appear on the list of accessible or inaccessible underlyings are requested to contact the FSMA's services before doing so.

4.2. When is the derivative component's strategy considered overly complex?

For the purposes of the moratorium, each of the following strategies is considered complex on account of the difficulty in determining the value offered by the product:

- where the distribution takes place via a teaser; specifically, a teaser refers to a product with a fixed return that does not apply throughout the lifetime of the product, with the exception of interest rate products. The strategy of interest rate products with a fixed return during at least half of the lifetime of the product is not considered complex;
- where the investor may incur capital loss as a result of the fall in the underlying without being able to participate to at least the same degree in the increase of the underlying;
- where a minimal change in the performance of the underlying can have a disproportionate impact on the repayment of the capital or on the payment of a return (e.g. strategy based on a digital option[7] or barrier options[8]);
- where the product is distributed as a product with capital protection when the capital protection built into the product is conditional[9].

4.3. When is the calculation formula overly complex?

The FSMA is of the opinion that, for the purposes of the moratorium, the calculation formula should not comprise more than three mechanisms. The annex to this Communication contains a list of mechanisms that have been taken into consideration for the application of this criterion.

The principle is to take account of all mechanisms that involve a calculation relating to the performance of the underlying, with the exception both of mechanisms that provide for a minimum return or that limit the volatility of the underlying (floor, "cliquet" and observation values based on average performance). The FSMA assumes that the latter mechanisms contain a concrete added value for the customer.

4.4. When is there insufficient transparency regarding the costs, credit risk and market value?

- If the promotional materials used by the distributor in order to market his products do not contain transparent communication about all costs that are included in the subscription price (e.g. structuring costs) or that are charged over and above the subscription price. It is

7 An option that confers a right to a fixed return or to no return.

8 An option where changes in the value depend on whether or not it reaches a pre-defined level of the underlying asset. If this level is reached, the option may be activated (knock-in option) or may expire (knock-out option).

9 A product can be distributed as a product with partial capital protection if the protection amounts to minimum 90% of the capital.

recommended that all costs included in the subscription price be presented as the percentage of the subscription price that corresponds to the difference between the subscription price on the one hand and the value of the savings and the derivative components on the other;

- if the product is not distributed in the name of the issuer, or where the name of the product makes an (implicit) reference to the distributor;
- if, after distribution, the market value of the product is not disclosed on the distributor's website at least quarterly[10], and where the distributor does not inform the holders of the product in case of a significant change in the risk profile or in the value of the product (e.g. a lowering of its rating). The distributor commits himself to providing the information in question at the time of distribution.

5. "to retail investors"

Retail investors are investors who do not qualify as professional clients within the meaning of Article 2, first paragraph, 28°, of the Law of 2 August 2002 (e.g. credit institution, insurance company, pension fund). This applies primarily to the individual investor residing in Belgium.

As mentioned under point 2, a distributor may, under certain conditions, choose an opt-out for retail investors who, at the time of the distribution, hold deposits and financial products with the distributor with a value of more than EUR 500,000.

6. Additional commitments

Distributors who voluntarily sign on to the moratorium, and who are not bound by law or regulation to submit their marketing materials on structured products to the FSMA for approval, are asked to provide the FSMA with this marketing documentation before distribution in order that compliance with the moratorium may be verified.

Distributors undertake to ensure that the information included in the marketing materials is sufficient and comprehensible for the group to whom they are addressed[11].

Distributors who voluntarily sign on to the moratorium undertake to disclose the value of the derivative and of the savings components to the FSMA prior to their distribution.

7. Notification of signing on to the moratorium

The FSMA will publish a list on its website of those credit institutions, investment firms, insurance companies, intermediaries in banking and investment services, insurance intermediaries and management companies of undertakings for collective investment that have voluntarily signed on to the moratorium.

---

10 If the distributor does not have a website, the information may be published on the issuer's website.

11 Cf. Art. 8, § 2, paragraph 3 of the Royal Decree of 3 June 2007 containing detailed rules transposing the European Directive on Markets in Financial Instruments, as well as Article 15, § 3, of the Royal Decree of 22 February 1991 containing general regulations relating to the supervision of insurance companies.

In the event that a group signs on voluntarily to the moratorium, all the legal entities within the group that have a sales channel in Belgium will be included individually on the list.

Distributors who have signed on to the moratorium are free to mention this fact in the marketing materials they use for distributing structured products after the entry into force of the moratorium, by inserting the following text:

"[Name of distributor] has voluntarily signed on to the moratorium on distributing particularly complex structured products to retail investors that has been proposed by the FSMA. This does not constitute a judgement as to the risks inherent in the product."

The FSMA asks distributors who voluntarily sign on to the moratorium to respect both its letter and its spirit.

8. Measures in the event of non-compliance with the moratorium

In the event of a failure to comply with the moratorium, the name of the distributor may be struck from the list.

9. Procedural aspects of signing on to the moratorium - information

9.1. For credit institutions, investment firms, insurance companies and management companies for undertakings for collective investment that wish to sign on to the moratorium, the FSMA has placed a form on its website that can be filled out, signed by the person(s) authorized to act for the distributor, and sent in to the FSMA in PDF format to accession.moratorium@fsma.be.

A group in which various entities with a sales channel are active in Belgium can only sign on to the moratorium if all the said entities of the group sign on. The form must in that case mention all the aforesaid entities of the group, and must be signed by the parent company in Belgium that controls the aforesaid entities.

9.2. The process whereby intermediaries in banking and investment services and insurance intermediaries can sign on will be announced later, after consultation with their professional organizations.

9.3. Questions regarding the moratorium may be sent to pro@fsma.be. Additional information may be found on www.fsma.be. The FSMA will publish a FAQ with answers to general questions.

10. Entry into force

The voluntary moratorium comes into effect on 1 August 2011. It applies to structured products whose distribution begins as from that date.

Sincerely yours,

Jean-Paul Servais
Chairman

Annex: Communication FSMA_2011_02-01/ Table of calculation mechanisms