ASIC

Australian Securities & Investments Commission

REPORT 201

Review of disclosure for capital protected products and retail structured or derivative products

July 2010

About this report

This report summarises ASIC’s key findings from our review of selected Product Disclosure Statements (PDSs) for capital protected products and other structured or derivative products marketed to retail investors.

We expect this report to be beneficial to issuers of these types of investments in helping them to meet their disclosure requirements so that consumers can make informed choices when considering the acquisition of these financial products.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not establish ASIC policy. For ASIC policy, see Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (RG 168).

Contents

Key findings and next steps

1 This report summarises ASIC's key concerns following our review of a number of PDSs for capital protected products and other structured or derivative products marketed to retail investors for compliance with their disclosure obligations. The products reviewed include foreign exchange (FX), futures, commodities, warrants, deferred purchase agreements (DPAs) and non-traditional managed funds with structured product-type exposure (such as those with inbuilt alternative asset class exposure, leverage or dynamic management).

2 The matters discussed in this report only encompass those issues we have identified to date as part of our review. We expect the findings of our review to be beneficial to issuers of these types of products in helping them meet their disclosure requirements. We intend to continue to review PDSs and take action where needed to promote better and more effective disclosure for these types of products.

General disclosure

More effective presentation

3 Given the complexity of some of the products offered, our review showed that there needs to be a greater emphasis on the effective presentation of information: see Section B. This includes giving consideration to the use of diagrams and other user-friendly tools, incorporating realistic examples to demonstrate particular points, limiting the use of defined terms, and giving appropriate prominence to both the risks and benefits of products being offered.

4 We consider issuers need to pay particular attention to these matters, having regard to their existing legal obligations to ensure that:

(a) PDSs are clear, concise and effective;

(b) there are no misleading or deceptive statements; and

(c) any required information is not omitted.

Ensuring key risks are not concealed

5 We considered that the disclosure was deficient in many of the PDSs we reviewed. In some cases, the disclosure was structured in such a way that key risks were concealed.

6 We were particularly concerned about the notably inadequate disclosure in the case of a number of funds investing in underlying funds located (or potentially located) in 'tax haven' jurisdictions. Our review concluded that many PDSs were seriously deficient in disclosing the investment strategy of the head fund and the underlying funds. Coupled with the inherent risks in investing in 'tax haven' jurisdictions, potential investors would be making a 'leap of faith' in investing in such funds.

Note: We will consider developing policy in this area to address inappropriate disclosure practices in the case of feeder funds and overseas jurisdictions.

Specific disclosure

7 Our review highlighted a number of specific disclosures that need to be improved in PDSs for capital protected products and other structured or derivative products marketed to retail investors.

Financial information about counterparties

8 PDSs need to clearly explain counterparty risk, and include supporting financial information, to ensure retail investors can assess the issuer's financial ability to meet its counterparty obligations: see Section C.

Risks of capital protected products

9 For capital protected products, disclosure should be sufficient to ensure that investors can adequately assess the likelihood of early termination or any other significant limitations of those products: see Section D. In particular, investors should understand that, while there may be capital protection for the amount invested, that amount may decline in value in the future, taking into account the 'time value of money'.

Disclosure of break costs

10 There needs to be better disclosure of break costs that may apply where an investor seeks to terminate or redeem a product before its maturity date: see Section E. Issuers need to consider whether it is appropriate to provide a broad indication in the PDS of the potential quantum of break costs, such as a range expressed as percentages of the amount invested by an investor. We consider the law will require disclosure of these costs in many cases.

Note: We will continue to carefully review PDSs for selected capital protected products and other structured and derivative products, paying particular attention to these issues.

Segregation and use of client money by issuers

11 As part of our review, we noted that in some cases there were serious disclosure deficiencies and differing industry practices relating to the client money provisions in Pt 7.8 of the *Corporations Act 2001* (Corporations Act). We have previously issued Consultation Paper 114 *Client money relating to dealing in OTC derivatives* (CP 114) to seek feedback from Australian financial services (AFS) licensees and their clients on our proposed guidance on the client money provisions and how we expect AFS licensees to comply with these provisions in the context of dealing in over-the-counter (OTC) derivatives.

12 We have recently issued two further regulatory documents regarding client money following from CP 114. These documents are Report 202 *Response to submissions on CP 114 Client money relating to dealing in OTC derivatives* (REP 202) and Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* (RG 212). Accordingly, this report does not address issues relating to the client money provisions.

Next steps

13 We intend to update Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (RG 168) to take into account the findings of this report.

14 We will also be engaging with the Australian Financial Markets Association (AFMA) for that body to provide product issuers with guidance on the arrangements they have in place for approving financial products for issue to retail clients.

A Background

Key points

This report presents ASIC's key disclosure concerns based on our two ongoing projects for review of selected PDSs offering:

- capital protected products; or
- complex or unusual structured or derivative products to retail investors, including foreign exchange (FX), futures, commodities, warrants, deferred purchase agreements (DPAs), and non-traditional managed funds with structured product-type exposure (such as those with inbuilt alternative asset class exposure, leverage or dynamic management).

In Sections B to E, we identify areas where we have consistently raised concerns with issuers. All matters that we raised in our review and discuss in this report are based on our existing guidance in RG 168. We expect that these findings will be beneficial to issuers of these types of financial products in helping them meet their disclosure requirements.

Scope of first project: Capital protected products

15 Our focus for this ongoing project has been to examine disclosure for products that investors may be attracted to because of a perception of capital safety. Investors could be attracted to financial products that are marketed, or perceived to be, as 'safe' as bank savings accounts or term deposit accounts, but which offer a potentially higher rate of return.

16 The primary risk that arises from investors being attracted to 'safe' financial products is that it may transpire that these financial products carry inherent risks that are not expected by the investor. A higher return is generally accompanied by higher risk, so a product marketed as having a higher return than another product, for the same level of risk, may well be marketed on the basis of misleading or deceptive statements.

17 Our PDS review for this project encompasses financial products that have capital protection. This includes interests in managed investment schemes and other financial products such as DPAs. For the purpose of narrowing our review, we focused on those PDSs that we considered had a higher risk of non-compliance with the disclosure requirements.

18 We consider that there is a higher risk of non-compliance with the disclosure requirements in PDSs for products where:

(a) there is a relatively complex structure (such as the use of DPAs);

(b) the counterparty risks of the body providing the capital protection may not have been effectively disclosed;

(c) there are conditions associated with the capital protection, such as knock-out or termination events, that may invalidate the protection; and

(d) there is a narrow scope to the capital protection that may not be readily appreciated by investors.

Scope of second project: Retail structured or derivative products

19 In our second project, we focused on structured or derivative products (without capital protection) that were being offered to retail investors. Products reviewed included DPAs, FX, warrants, futures, commodities and non-traditional managed funds with structured product-type exposure (such as those with inbuilt alternative asset class exposure, leverage or dynamic management).

20 Within the identified product categories, we focused on those PDSs that we considered carried a higher risk of non-compliance with the disclosure requirements, such as those where:

(a) there are risks that may be less likely to be disclosed by product issuers, such as foreign exchange or interest rate impact;

(b) an issuer that acts as market-maker has a potentially high credit risk, unknown operational and risk controls, and/or a low level of experience; and

(c) new or emerging products are being offered by a product issuer with no track record.

Contracts for difference (CFDs)

21 This report does not address our reviews of PDSs offering CFDs. We have recently issued a separate report, Report 205 *Contracts for difference and retail investors* (REP 205), which outlines the findings of our reviews of CFD PDSs. You should refer to this report for information about, for example, communicating information effectively in PDSs.

Documents reviewed

22 For both projects, we selected the PDSs by:

(a) reviewing the PDS in-use notices lodged with us to identify PDSs being used to offer financial products;

(b) assessing complaints made to us about the relevant financial products;

(c) assessing market information from the media and other sources; and

(d) reviewing websites of product issuers.

23 It is important to note that our projects involved reviewing *selected* PDSs. We do not 'approve' or review all PDSs that are in use.

Product issuer information

24 As at 6 April 2010, we had reviewed 64 PDSs as part of these projects. These PDSs were issued by the types of issuers listed in Table 1.

Table 1: Product issuer classification

Type of issuer	Number of PDSs reviewed
Investment banks and asset management arms of investment banks	22
OTC issuers (e.g. FX providers)	24
Commercial banks (including investment banking and asset management arms of commercial banks)	7
Fund managers (other than those owned by the above three types)	11

Financial product information

25 As at 6 April 2010, the financial products offered under the PDSs we reviewed could be broadly classified as the types listed in Table 2.

Table 2: Product type classification

Type of financial product	Number of PDSs reviewed
Capital protected	19
Commodities	2
DPAs (no capital protection)	3
Futures	3
FX (including margin FX and FX options)	13
Managed investment schemes with structured product-type exposure (such as alternative asset class exposure, leverage or dynamic management)	8
Protected equity loan	1
Shorting	1
Warrants	4
Multiple products	8
Other	2

Our regulatory approach

26 RG 168.78–RG 168.79 relevantly states:

> Where we detect or are made aware of valid *prima facie* disclosure concerns about a PDS, we may notify the issuer of our concerns before serving an interim stop order.
>
> However, if delay could be prejudicial to the public interest, we will impose an interim stop order without consulting the issuer, pending resolution of our concerns at a hearing.

27 While there are alternative regulatory approaches to deal with the concerns arising from our review, our initial aim was to engage with industry to address any issues identified.

28 To that end, we advised AFMA of these projects at an early stage, and product issuers were contacted on a case-by-case basis, as issues were identified during our review. We sent findings letters to those issuers to endeavour to obtain corrective disclosure, rather than immediately making a stop order, while also noting that we considered our stop order remedy to be available. We believe that this has been an effective regulatory approach for these projects, although this should not be seen as a statement of our policy or indicate future practice in this area.

B Presentation

Key points

Improving the presentation of a PDS involves conveying the required information in a form that is more easily understood.

Product issuers improved the presentation of their PDSs by:

- using more diagrams and graphs (see paragraphs 29–30);
- using realistic examples (see paragraphs 31–36);
- limiting the use of defined terms, and using plain, clear language rather than jargon and technical terms (see paragraphs 37–39); and
- ensuring disclosure was clear, concise and effective (see paragraphs 40–42).

Our review showed that issuers need to focus on ensuring that:

- statements are not misleading or deceptive, including giving greater prominence to both risks and benefits, and ensuring product return comparisons are made with particular care (see paragraphs 43–49); and
- no required information is omitted (see paragraphs 50–52).

Using diagrams and other user-friendly tools

29 As noted in RG 168.49, we consider diagrams are a useful way of explaining the workings of a product and, in particular, how the product generates a return for the investor. This includes, if applicable, how any capital protection operates.

30 In appropriate cases, we requested issuers to include a diagram as a supplement to their textual description. This was particularly important where a complicated issue was being explained. Given the complex nature of the products, the disclosure in many of the PDSs we reviewed would have been deficient but for the use of diagrams or other user-friendly tools to show how the products worked.

Using realistic examples

31 Appropriate examples are generally useful for retail investors to help illustrate how a product operates. More effective examples use scenarios that show both growth and decline in important attributes (such as positive and negative investment performance). In many cases, we considered that examples would assist issuers to comply with the obligation under s1013C(3) of the Corporations Act that a PDS must be clear, concise and effective.

32 The assumptions adopted in the examples should be relevant to the product. For instance, a notional transaction amount in an example that is less than the minimum transaction amount stated in the PDS could be confusing for retail investors, as well as misleading or deceptive.

33 A particularly poor case of disclosure arose in the context of an offer of OTC derivatives to retail investors by an issuer acting as a market-maker. An example was included to show the difference between the offered OTC product and trading in the underlying securities (without using the OTC product) on a financial market. The same purchase price was used for both, yet the PDS disclosed that the price of the OTC product could be different from that available if the securities relating to the OTC product were traded on a financial market. We considered that this example could be misleading or deceptive.

34 We also raised another concern with a product issuer about the complexity of its product and the use of examples to attempt to explain it. In that case, the PDS disclosed a method of calculating the termination value of a product. The formulaic method for calculating this value was extremely complex, yet no examples were used to directly show how the formula applied. Further, while some examples were included to show broadly how the product operated, they did not show the final amount that would be received by an investor in differing market circumstances. We considered that the PDS, as originally drafted, would have been of little value to potential investors.

35 To the extent practicable, assumptions should be consistent across different examples included in a PDS. For instance, if an example is included to show the value on exercise of a derivative and an assumption is made as to the amount of expenses involved in that exercise (e.g. the costs of unwinding the hedging arrangements), the same assumption should be used when the value is calculated in another scenario (e.g. in a stop loss event). Alternatively, there should be a clear explanation as to why it is appropriate to make different assumptions for different calculations.

36 Assumptions need to be reasonable in the circumstances, which also necessitates consideration of whether significant fluctuations in economic conditions would mean that assumptions that would formerly have been reasonable might not be reasonable in the future. It is beneficial to be able to demonstrate the effect of these assumptions—that is, to show the results under different scenarios if the key assumptions are varied. We encouraged examples that take into account best and worst case scenarios to ‘stress-test’ the performance of products under various conditions. Sensitivity tables are an effective way of showing this.

Limiting the use of defined terms

37 Where too many defined terms are used, it is likely to confuse retail investors and reduce the clarity of disclosure. This is because the reader needs to regularly refer back to the 'definitions' or 'glossary' pages and then re-read the section with the defined terms in mind.

38 However, some definitions are generally appropriate if used judiciously. It is helpful to investors to collate the definitions in a glossary section, usually at the end of the PDS, with a prominent statement referring investors to that section at the front of the PDS. Defined terms should be clearly identified—for example, by the term being capitalised.

Note: Although we did not specifically raise this with product issuers, we did consider whether PDSs should include disclosure to confirm that capitalised terms are defined terms to allow for the wide class of readers and potential retail investors who use disclosure documents to make financial decisions and who may not be aware of this practice. This may be an issue that we revisit in the future.

39 The complex features of some products, and the need to explain the components of those features, means that product issuers need to take particular care to ensure their PDSs are readable. Issuers should use plain, clear language rather than jargon or technical terms. In one case, the PDS used a number of defined terms early on in the document, and those terms (being capitalised) were defined in a glossary. However, the definitions of those terms in the glossary referred to other defined terms, and those terms were, in turn, explained throughout the PDS in various places. This meant that, within a very short time of beginning to read the PDS, a potential investor would have needed to traverse the entire document to understand the defined terms used in the initial descriptions.

Ensuring disclosure is clear, concise and effective

40 Due to the obligation in s1013C(3) of the Corporations Act, we raised concerns with issuers when we were not satisfied that the disclosure was clear, concise and effective. In one instance, we were concerned that the disclosure of a large 'block' of text about the operation of a complex product would be very difficult for an investor to understand, and that the PDS in this regard did not comply with the obligation to be clear, concise and effective.

41 In other instances, we raised concerns with product issuers about the disclosure in relation to the level of margin required to be maintained by clients trading in OTC derivatives. For example, we considered that a PDS we reviewed was not clear, concise and effective because the product issuer stated that it was able to close out positions without any notice to its clients if the margin fell below a certain level. Despite this, the PDS did not contain any disclosure about how clients were able to monitor their margin level.

42 Issuers should aim to produce short and concise documents that are well presented and specific to the particular product they are offering. While related products, such as FX and FX options, may be offered in the same PDS, in reviewing various PDSs, we took the view that it would be very difficult for products that have quite different features to be offered in this way.

Ensuring statements are not misleading or deceptive

Prominence of both risks and benefits

43 For any product, information about both its risks and benefits should be given similar prominence in a PDS. Otherwise, the PDS could be misleading or deceptive because of the way that it is presented. The importance of this is discussed in RG 168.65–RG 168.68.

44 For example, if a PDS describes the leverage available by acquiring a derivative product as a key benefit, it is important to refer to the fact that this leverage also exposes an investor to amplified losses on adverse price movements.

45 One way that this can be done is by incorporating a specific cross-reference from the point where a benefit is being discussed to the description of the corresponding risk located in the risks section of the PDS.

46 Each risk should be clearly described, and each key risk should be separately identified by an appropriately prominent heading. Lengthy, unstructured and/or boilerplate risk disclosures are less likely to meet disclosure requirements.

Product return comparisons

47 Issuers should take particular care when comparing product returns to the past performance returns of a benchmark such as an index, a related fund or a wholesale fund into which the retail fund being offered will invest. Such a comparison could be misleading or deceptive if the returns are not comparable due to significant product differences: see also RG 168.102.

48 For example, one PDS disclosed an investment return and implied that this was representative of the managed investment product being offered. Yet the return was for a managed investment product that differed to the one being offered in the PDS in a number of material ways (including the risks faced by investors). Further, the PDS contained statements about the withdrawal notice and redemption payment periods for a holder of the managed investment product that were not indicative of the maximum periods allowed for the investment.

49 During our reviews, we considered that if a graph was included to show the return of another fund, the graph should be accompanied by very clear disclosure to explain the relevance of its inclusion and to clearly explain that the return under the offered product might not be as high as that achieved under the other fund: see also RG 168.102.

Ensuring no required information is omitted

50 The omission of disclosure about the investment strategy of a fund is very likely to be a serious infringement of the disclosure obligations in Pt 7.9 of the Corporations Act. If a managed investment product offers the ability to obtain exposure to a number of underlying funds, there should be specific information about the investment strategy of those underlying funds. This information is necessary to enable a potential investor to properly assess the risks involved. This information is particularly important if the underlying funds are located in overseas ‘tax haven’ jurisdictions, as this increases the risks faced by investors: see paragraph 52.

51 For example, we raised concerns about the lack of disclosure of investment strategy in relation to a managed fund. In this case, there was seriously inadequate disclosure about the markets that particular units in the fund were exposed to, and there was no clear indication of whether the underlying trusts used by the fund were domiciled in Australia or overseas. Compounding this inadequate disclosure was particularly poor disclosure about the use of leverage. This meant that a reader of the PDS could not ascertain the extent to which leverage was used by the underlying funds. The product issuer agreed to include more detail about these issues in making corrective disclosure.

52 We were particularly concerned about these issues because of:

(a) the use of the ‘feeder fund’ structure (where an investor obtains an interest in a head fund, which then invests in underlying funds)—our view was that this increased the risk to investors because there were more structures interposed between the investors and the actual assets;

(b) the fact that the underlying funds were potentially located outside Australia—our view was that this increased the risk to investors because investors might be exposed to jurisdictional risks; and

(c) the lack of disclosure about the investment strategy of the fund—our view was that, without clear disclosure of this strategy, investors would be merely taking a ‘leap of faith’ in making an investment.

C Counterparty risk

Key points

OTC structured or derivative products issued by an issuer that acts as a principal/market-maker generally involve a retail investor bearing the risk of the issuer failing to meet its obligations. This is counterparty risk.

Some products, such as capital protected products, involve a retail investor bearing counterparty risk of the issuer and at least one other counterparty—in this case, the provider of the capital protection.

Retail investors need to be provided with sufficient information in the PDS to adequately assess counterparty risk, and disclosure should be sufficiently prominent to reflect the nature of the risk: see paragraphs 53–55.

In our review, we consistently noted instances where insufficient financial information had been made available to investors: see paragraphs 56–59.

Explaining counterparty risk

53 Complex products are offered in the form of a contract between the investor and the issuer. By acquiring the product, an investor is exposed to the risk that the issuer may not be able to perform some or all of its obligations under the contract. This is generally referred to as counterparty risk.

54 For instance, capital protection is sold to investors as providing protection if some or all of the underlying investment suffers losses, but that protection is dependent on the provider of the capital protection not defaulting on its obligations to provide the protection.

55 Consistent with the guidance in RG 168.66, we consider that PDSs need to clearly explain the existence of counterparty risk to potential investors. Issuers should ensure the PDS also clearly discloses that potential investors can assess the issuer's financial ability to meet its counterparty obligations by reviewing its financial information. It is best practice that this risk disclosure is prominent—for example, by appearing within the first few pages of the PDS. To the extent other factors may impact on counterparty risk, we will give consideration to requesting disclosure of those matters.

Providing supporting financial information

56 Counterparty risk disclosure should be supported by the disclosure of sufficient information in the PDS to allow potential investors to assess the risk. If the issuer's financial information is already publicly available, then we consider it satisfactory for the issuer to include information as to how a

retail investor could obtain access to the information free of charge—for example, by accessing the issuer's website.

57 Where the relevant financial information is not already in the public domain, a summary of key financial information should be included in the PDS. Alternatively, the PDS should contain details about how a potential investor could obtain the latest financial statements free of charge—for example, by telephoning a toll-free number to the issuer's office for the information to be posted to them.

58 In our review of PDSs, we noted one instance where an issuer sought to address our concerns by reference to previously published financial reports of the parent entity and the group. We considered that this was misleading or deceptive, as neither the parent entity nor the group companies guaranteed the obligations of the issuer.

59 We also noted an instance where an issuer sought to assure potential investors of its financial position merely by including in the PDS a statement to the effect that the issuer must comply with the financial requirements imposed under its AFS licence, including an annual audit. We considered this misleading or deceptive, as it implied that the mere existence of the AFS licence financial conditions meant that the product issuer would be able to meet its counterparty obligations (even if, in fact, the product issuer was not complying with those conditions). The AFS licence financial conditions are not designed with this purpose in mind.

Disclosing related counterparty risk

60 Some complex products can also involve an investor bearing counterparty risk to parties other than the issuer—for example, a counterparty to a hedging contract taken out by the issuer (hedging counterparty). It is also necessary for the issuer to include analogous disclosures relating to counterparty risk for these parties. One way to address this is to disclose the issuer's criteria for choosing the hedging counterparties. We may seek disclosure of the identities of the hedging counterparties used by an issuer because, given the small number of hedging counterparties is a risk, then investors need to know the identity of the hedging counterparties in order to fully understand this risk.

D Capital protection

Key points

Consistent with RG 168, PDSs should disclose:

- a description of the actual protection offered by the capital protection (see paragraphs 61–62);
- the conditions attached to the capital protection (see paragraphs 63–64); and
- the discretions available to the provider of the capital protection (see paragraphs 65–67).

Given its importance, this disclosure should be sufficiently prominent—for example, it might be presented within the first few pages of the PDS.

Our review further highlighted the need for issuers to clearly disclose:

- the proportion of funds invested for capital protection (see paragraphs 68–69); and
- the effect of the time value of money on the future value of investments (see paragraph 70).

Making the nature of the protection clear

61 It is important that a clear description of the protection offered by the capital protection is included in PDSs for capital protected products. Protection should not be described as being unlimited and unconditional if it does not apply in cases of early maturity. In this circumstance, we consider an unconditional statement would be misleading or deceptive.

62 Our review has raised particular concerns about whether disclosure is sufficiently clear in regard to the priority investors would receive from capital protection in the event of a winding-up. For example, if investors rank as unsecured creditors, any capital protection is only as good as the entity providing it. This is consistent with our position relating to the disclosure of counterparty risk: see Section C. This disclosure should be sufficiently prominent—for example, appearing in the first few pages of the PDS.

Disclosing conditions attached to the protection

63 A common feature of capital protected products is the inclusion of early maturity (or termination) events, where the issuer has the discretion to terminate the product prior to maturity upon the happening of any one of a number of events. The structure of some products means that, where early maturity occurs, the capital protection ends.

64 It is therefore important for early maturity events to be prominently disclosed in the PDS as key product information. In various PDSs that we reviewed, we obtained corrective disclosure to ensure investors were aware of the risk that the happening of a certain event (such as insolvency in the case of an underlying asset) meant that they would potentially receive no return of their funds.

Disclosing discretions available to issuers

65 Any discretions associated with the capital protection, and how these might be exercised, should be made clear in the PDS.

66 We obtained corrective disclosure relating to the occurrence of an early maturity event. In this case, the capital protected product operated over a number of years, but could mature earlier. We observed the disclosure of early maturity events within the body of the PDS, yet the discretions of the issuer relating to calling these events were only disclosed in the contract terms section. We did not consider this to be effective disclosure, and obtained corrective disclosure to ensure the existence of these events was given equal prominence to the disclosure of their description.

67 Where the issuer offers a liquidity facility for a product to investors, disclosure in the PDS should clearly cover any discretion the issuer has to cease offering the liquidity facility. Disclosure should make it clear that, if the liquidity facility is ceased, then investors might not be able to realise the value of their investment prior to the maturity of the product.

Disclosing the proportion of funds allocated for protection

68 We observed capital protected products that invested a significant (and often major) proportion of the funds in a fixed term and fixed income product (such as unsecured notes or term deposits). The rest of the funds were then invested in higher risk products, which potentially offered higher returns but also risked total or partial loss of the investment. The funds invested in the fixed term and fixed income product were expected to grow by the end of the term to equal the amount of the capital protection.

69 In one case, we were concerned about the lack of disclosure about the proportion of funds invested for capital protection and the proportion remaining for other investments. As the proportions of allocations between the fixed income product and the higher risk products affected the risk–return profile of the product being offered, we took the view that it was necessary for the proportions to be clearly disclosed in the PDS and that not to do so meant the PDS was omitting required information.

Disclosing the time value of money

70 Many capital protected products have a long maturity period. It is important for investors to understand that, while there may be capital protection for the amount invested, that amount may decline in value in the future, taking into account the 'time value of money'. We consider that specific examples illustrating this issue would be useful.

E Break costs

Key points

We observed a number of instances where the disclosure about break costs was inadequate, particularly in relation to capital protected products: see paragraphs 71–73.

Where actual amounts cannot be calculated, we consider that issuers should, as a minimum, provide relevant information such as an indication of the factors that affect break costs: see paragraphs 74–75.

Disclosing the potential quantum of break costs

71 We observed a number of instances, particularly in relation to capital protected products, where the existence of break costs on early termination or maturity was disclosed, although without giving any indication of the potential quantum of those break costs, or the factors that would determine the size of the break costs.

72 An example of this is:

> The issuer may deduct Break Costs in relation to Early Maturity or Early Buy-Back. The Break Costs will form part of the calculation of the amount you will receive if your Early Buy-Back request is permitted.

73 We do not consider this disclosure to be acceptable because it does not disclose the potential amount of the break costs, how the break costs would be calculated or the factors that would influence the actual amount of the break costs.

Ensuring minimum disclosure requirements are met

74 Several product issuers indicated that the actual break costs could not be accurately estimated at the time of preparing the PDS. Where investors may be subject to break costs, we consider that issuers may address this by disclosing in the PDS, as a minimum:

(a) that break costs could be significant and are therefore a risk;

(b) that an estimate of the break costs will be provided to investors on request at the time they wish to terminate early; and

(c) a description of the main factors affecting the calculation of the break costs, including, for example, the cost of unwinding hedge positions.

75 Issuers also need to consider whether it is appropriate to provide a broad indication in the PDS of the potential quantum of break costs, such as a range expressed as percentages of the amount invested by an investor. We consider the law will require disclosure of these costs in many cases and we will inquire as to why they have not been included in appropriate cases.

Key terms

Term	Meaning in this document
AFMA	Australian Financial Markets Association
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries out a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an Australian financial services licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
ASIC	Australian Securities and Investments Commission
DPA	Deferred purchase agreement
CFD	Contract for difference
Corporations Act	*Corporations Act 2001* (Cth), including regulations made for the purposes of that Act
FX	Foreign exchange
OTC	Over-the-counter
PDS	Product Disclosure Statement
Pt 7.8 (for example)	A part in the Corporations Act (in this example numbered 7.8)
s1013C (for example)	A section of the Corporations Act (in this example, numbered 1013C), unless otherwise specified

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