ASIC

Australian Securities & Investments Commission

REPORT 340

'Capital protected' and 'capital guaranteed' retail structured products

May 2013

About this report

This report summarises the results of a 'health check', conducted in 2012, on the market in Australia for unlisted and unquoted 'capital protected' and 'capital guaranteed' retail structured products. It provides a review of the structured product market, and reports on product features and risks, current marketing practices, investor attitudes and behaviour, and consumer complaints.

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.

Contents

Executive summary

1 'Capital protected' and 'capital guaranteed' retail structured products can provide investors with exposure to growth assets in times of positive market performance, and downside protection when markets fall. They may also provide investors with leverage and tax advantages in some cases.

2 However, these products also entail complexities, conditions and risks that are not always well understood by retail investors. Qualitative research commissioned by ASIC found that consumers often have a poor understanding of the structured products they invest in, which may lead to unanticipated outcomes, particularly when reference assets underperform.

3 This problem is accentuated by the labelling or description of certain structured products as 'capital protected', despite all of the investor's outlay being at risk of loss. For such products, labels such as 'capital protected' can create a perception of safety that is inconsistent with the product's features and risks. This perception of safety may be reinforced when the product issuer or protection provider is a recognised and trusted bank or other large financial institution.

4 We consider that the phrase 'capital protected' or 'capital guaranteed' will ordinarily be understood by an investor to mean that their capital cannot be lost. The use of terms such as 'qualified', 'limited', 'conditional' or 'contingent' in conjunction with the phrase 'capital protected' or 'capital guaranteed' may not be sufficient to avoid the phrase as a whole being likely to mislead or deceive consumers about the risk to their capital, particularly where, if certain conditions are met, the whole of the capital will be at risk. We do not believe that labels and descriptions such as contingent or conditional capital protection help consumers, and consider that, in some cases, these terms may be actively misleading.

5 This report also identifies our concerns with the promotion of some 'internally geared' structured products, where consumers may have been misled by disclosure and marketing documents that describe these products as entailing a 'capital protected loan', but where the leverage is 'notional'. The qualitative research also found that investors in some leveraged products did not understand that their outlay was not capital protected.

6 We have written to a number of issuers in relation to these and other concerns, resulting in amended promotional materials. We are continuing to monitor whether, in some of these cases, further action is required. Where we see future instances of inappropriate or potentially misleading or deceptive promotional material, we will take strong action.

7 We note the Australian Financial Markets Association's (AFMA) initiatives to raise industry standards, with voluntary standards for members in the development, approval, suitability assessment and distribution of structured

products: see AFMA’s *Principles relating to product approval—Retail structured financial products* (October 2012). These principles:

> … are intended to support the product development and distribution process within firms that issue retail structured financial products by clarifying the respective roles and responsibilities of the various parties involved in a manner that promotes the fair treatment of individual investors.

8 Where significant issues in the market persist, we will consider appropriate regulatory options, particularly in relation to the description of medium-risk and high-risk financial products using terms such as ‘capital protected’.

9 We will finalise the results of our current review of a sample of personal advice files on structured products shortly, and will take follow-up actions as appropriate. These may include feedback to individual Australian financial services (AFS) licensees, further surveillance, enforcement actions, and a public report summarising the findings of the review.

A Introduction

'Capital protected' and 'capital guaranteed' products

10 Uncertainty in financial markets and a low interest rate environment have prompted many retail investors in Australia to seek shelter in conservative investments. While this has led to large inflows of funds to cash and term deposits in recent years, some people continue to be attracted to more complex investments that also offer to 'protect' or 'guarantee' their capital—or offer attractive yields or market exposure, or a combination of both.

11 These investments include 'capital protected' and 'capital guaranteed' retail structured products, which are the subject of this report. In this report, we define 'structured products' as a promise by a company to pay investors a return that is usually based on the movement in the value of reference assets, such as a share index, securities or other assets, generally using derivatives arrangements. They range from relatively simple investments, which are likely to at least return the investor's initial investment at maturity, to highly geared or speculative structured products where all the retail investor's outlay (capital) is at risk.

12 The attractions of these products for investors may include the ability to participate in the upside of market performance, while having protection on the downside—as well as potential tax advantages in some cases. However, the opaque and complex nature of some of these products can render their features and risks difficult for retail investors to understand. Labelling and brand recognition may distract investors from investigating the underlying risks. As a result, some retail investors may not appreciate the risk–return profile of the investments—or understand what, if anything, is being protected—resulting in investments that are unsuitable for investors' needs or products that do not perform as expected.

13 Overseas, and to some extent in Australia, the global financial crisis exposed significant gaps between retail investors' expectations of structured products, how they were marketed or sold, and how the products performed in stressful market conditions. In some cases, products that were perceived by investors as safe or conservative turned out to be risky.

14 In the past, we have identified and taken regulatory action on problems in the disclosure, marketing and distribution of certain retail structured products, as well as deficient financial advice. In July 2010, we published Report 201 *Review of disclosure for capital protected products and retail structured or derivative products* (REP 201), the findings of which were reflected in an update of Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (RG 168). We have also highlighted the features and risks of these complex products through MoneySmart—ASIC's website for investors and financial consumers—at www.moneysmart.gov.au.

Purpose and scope of this report

15 This report provides a ‘health check’ of the Australian market for unlisted and unquoted retail structured products that are described as having some element of capital protection or capital guarantee. The aims of the report and project are to:

(a) review the market for these products in Australia;

(b) identify the risks posed to consumers and retail investors (these terms are used interchangeably in the report);

(c) report on the findings of qualitative retail investor research;

(d) review a sample of retail investor complaints ASIC received in relation to these products; and

(e) identify current practices in the labelling, description and promotion of these products.

16 We are also assessing the features and appropriateness of a sample of personal advice files on these products. We may publish the findings of this advice review in a separate report.

17 Products within the scope of this report include over-the-counter (OTC) structured products that purport to offer some form of capital protection or capital guarantee. We also include limited recourse loans, which may be ‘standalone’ loans, or a loan embedded in a structured product. ‘Reverse convertibles’ are also within the scope of this report—that is, products where the return of the investor’s capital is tied to the performance of assets such as shares (described in more detail in Section C). While ASIC considers these to be ‘capital-at-risk’ products, rather than offering capital protection, some issuers describe these products as having ‘conditional’ or ‘contingent’ capital protection.

Note: In this report, unless otherwise specified, references to ‘structured products’ mean unlisted and unquoted retail structured products that are traded over the counter.

18 Products outside the scope of this report include deposits with Australian authorised deposit-taking institutions (ADIs), ‘capital guaranteed’ superannuation funds, life insurance annuities, and ‘variable annuities’ which may be used to generate a retirement income stream. However, some of the issues raised in this report may be relevant to the issuers and distributors of these products.

19 Most exchange-traded structured products are also excluded, although we note that some OTC structured products sold directly to retail investors, such as deferred purchase agreement warrants, may also be quoted on the Australian Securities Exchange (ASX).

Key issues

'Protected' and 'guaranteed' may not be 'true to label'

20 The consumer research described in this report found that the terms 'capital protected' and 'capital guaranteed', which are inconsistently applied across the financial services industry, may be misunderstood by retail investors. These terms can have a strong emotional and behavioural pull on investors, creating the perception of a safe investment, and influencing their decision to invest. This is especially the case when the provider of the protection or guarantee is a trusted bank or other large financial institution.

21 Retail investors often consider 'capital protection' to be the equivalent of a 'capital guarantee', thinking that in both cases their entire capital will be returned, and that the investment has the unequivocal 'backing' of the bank or product issuer. However, structured products may have higher risks and less investor protection than other retail banking products, such as term deposits.

22 Structured products are often complex in nature, with significant qualifications and conditions associated with the protection, creating the concern that the use of labels such as 'protected' or 'guaranteed', or variations of these terms, may be inappropriate for some of these products.

Potential losses from 'capital protected' products

23 Some structured products promoted as 'capital protected' involve a significant potential for investors to lose money. Examples include the following:

(a) *Structured products with internal gearing*: With some of these products, all of the investor's outlay of prepaid loan interest and fees, or the cost of obtaining exposure to the performance of reference assets, is at risk of potential loss. Where the product entails a loan, the loan is generally limited recourse. Where a loan does not exist, but rather an investment exposure is created 'synthetically' with the use of derivatives, the investor's maximum loss at maturity may also be the money they have already paid (i.e. potentially a 100% loss of capital invested, less any benefits or income received).

(b) *Products described as having 'conditional' capital protection:* In this case, the return of the investor's capital is typically linked to the performance of shares or commodities. The investor may lose some, or even all, of the capital they invest, depending on the performance of reference assets.

24 It is not ASIC's role to determine whether these products are suitable for all investors. However, some investors may acquire structured products that are riskier than they realise, and which subsequently do not perform as they expect. For example, some investors may consider structured products to be equivalent, or a near equivalent, to cash or deposit accounts, when the risks of structured products are usually considerably higher. The labelling, description

and promotion of some of these products may contribute to this, while lengthy and complex disclosure documents may be difficult for investors to understand and are often not read in their entirety. ASIC aims to promote clear, concise and effective disclosure in these product disclosure documents, and to encourage advertising of financial products and services that not only meets the minimum requirement of not being misleading or deceptive, but also helps consumers to make appropriate decisions.

Information asymmetries

25 Structured products can be opaque and complex. For retail investors, these products can be difficult to understand. The relationship between product issuers and investors is starkly asymmetric, and in some cases product disclosure, marketing and financial advice have been unable to bridge this gap in consumer knowledge and understanding.

26 Often, the retail investor in these transactions may not fully understand the product's payoff profile, or the risks of buying or selling a derivative (which is often the economic effect of their transaction, even if its legal characterisation differs). Further, the opaque and embedded nature of the fee structure and margins may mean that investors pay relatively higher fees or receive lower returns than they realise.

Business model risks

27 Some structured products are issued through special purpose vehicles (SPVs)—entities that are established for the sole purpose of issuing the products, with no other business activities. Some of these entities do not have an AFS licence, but issue products through a licensed 'arranger': see Table 2. Many of these SPVs have little financial substance, and there may be significant additional risks for retail investors associated with these types of arrangements (these risks are disclosed in Product Disclosure Statements (PDSs)). For a further discussion of SPVs, see Table 2 in Section B.

28 Some structured products retain the branding of an investment bank or other financial institution despite having been issued by a separate and unrelated company. Retail investors may be under the misapprehension that a product has been issued by a particular financial institution that they recognise and trust, when in fact the issuer is a separate entity.

Some retail investors have a poor understanding of the products

29 Consumer research commissioned by ASIC found a number of problems for retail investors investing in structured products. Retail investors:

(a) often paid little attention to disclosure documents;

(b) tended to be heavily influenced by product labels and terms such as 'protected' and 'guaranteed';

(c) showed a poor understanding of how these products function, the risks, and the outcomes they can expect;

(d) did not appreciate the use of derivatives and the 'synthetic' nature of their investments;

(e) in some cases, received poor financial advice or poor communication from product issuers; and

(f) did not know that the investment contained an underlying contingent option product, which was often described in legal jargon.

Advertising and promotion standards vary

30 In financial services, generally, consumers are heavily influenced by advertising. For structured products, in particular, investors may be drawn to advertisements that use labels such as 'protected', 'secure' or 'guaranteed'. We identified some cases where the advertising and promotion of structured products:

(a) understated the potential risks of structured products;

(b) inappropriately stated that products were suitable for conservative or term deposit investors;

(c) labelled or described products with language that may have misled investors;

(d) used jargon and terminology that was not explained, or was unlikely to have been understood; and

(e) provided case study scenarios that only showed positive potential outcomes, without the potential downsides and risks.

31 We are contacting a range of product issuers and distributors to seek remedies that address these concerns.

Tax status is unclear or misrepresented

32 While this report does not focus on taxation issues, we are concerned that, in some cases, advisers and product manufacturers may have encouraged retail investors to claim tax deductions on internally geared products that do not have an Australian Taxation Office (ATO) product ruling. While rulings are not mandatory, some of these products and investments may be at risk of being viewed as tax avoidance schemes. The ATO has issued a number of public warnings to this effect.

Disclosure may be inadequate

33 In July 2010, we published REP 201, which included some of ASIC's analysis of PDSs for investments in capital protected products and retail structured or derivative products.

34 In relation to PDSs for capital protected and capital guaranteed products, REP 201 highlighted the need for issuers to clearly disclose a range of issues, including:

(a) the proportion of funds the issuer invests to create the capital protection, and the proportion used to invest or trade in riskier products; and

(b) the effect of the time value of money on the future value of investments, including specific examples to illustrate the impact of inflation on a ‘capital protected’ amount.

35 We have not included a further analysis of PDSs in this report. However, we make the following observations on the quality of disclosure and performance, as measured against REP 201:

(a) the proportion of funds allocated to the different ‘building blocks’ of the structured product, such as zero coupon bonds and call options (both terms are explained from paragraph 77), is sometimes, but not usually, disclosed; and

(b) PDSs often make broad statements about the impact or risk of the time value of money, but rarely provide simple examples of the ‘real’ (inflation-adjusted) value of a ‘capital protected’ amount at maturity.

36 We also make these additional observations:

(a) PDSs often use multiple pages of legal and technical language to describe payoff features. However, these documents may be more clear, concise and effective if they:

(i) state the nature or type of the underlying product; and

(ii) explain what this means for investors in words they are likely to understand (e.g. ‘the money you get back at maturity may be equivalent to the worst performing reference share’).

(b) Some of the risks in these products are extremely difficult for average retail investors to understand and assess. For example, product issuers often reserve the right to cancel capital protection and terminate the product due to an early termination event, such as a ‘tax event’, ‘legislative event’ or ‘hedging disruption event’. There is little, if any, disclosure of the potential likelihood of these events occurring, so retail investors cannot be expected to understand what weight to give to these risks in their decision making.

(c) In some cases, there are inconsistencies in the description of product features and risks between PDSs and marketing materials, creating potential confusion among investors. It is important that marketing and disclosure documents take a consistent approach, particularly in the labelling and description of features and risks.

B Market, issuers and business models

Key points

There were approximately 32,000 retail investors in 'capital protected' or 'capital guaranteed' structured products in Australia in 2012, according to research by Investment Trends.

Structured products are predominantly issued by investment banks and retail banks. Other issuers include 'boutique' (non-banking) AFS licensees, specialist responsible entities and special purpose vehicles (SPVs).

The products are primarily distributed to retail investors with personal advice, although direct sales and general advice models are also used.

Market size

37 By the end of October 2012, the total outstanding volume of retail structured products promoted with a 100% capital protection or guarantee in Australia was approximately $12 billion, according to Structured Retail Products.[1] The research company estimated that a volume of approximately $3.2 billion would mature in 2013.[2]

38 However, it is important to note that these figures include the value of 'notional' investment exposures created through leveraged structured products, and may substantially overstate the market size in terms of dollar sales. Structured Retail Products estimates the actual annual sales value of this market to be closer to $500 million per year in recent years, excluding limited recourse 'protected equity' loans, structured products with internal leverage and 'capital-at-risk' products.

39 In the context of the wider retail financial services market in Australia, these are relatively small figures. For example, in February 2013, household deposits (including term deposits) on the Australian books of individual banks were worth $590 billion, while total superannuation assets were estimated at $1.4 trillion in June 2012, according to Australian Prudential Regulation Authority (APRA) statistics.[3]

[1] Structured Retail Products (www.structuredretailproducts.com) describes itself as the leading online information source for the structured products market worldwide, covering 72 countries, and with a database of the sales and trends for retail structured products in these countries.

[2] The majority of these figures for retail structured products relate to unquoted and unlisted (i.e. OTC) products, but also include exchange-traded deferred purchase agreement warrants. The Structured Retail Products figures do not include investments promoted as having a 'conditional' capital protection, which are classified in a separate 'capital-at-risk' product category.

[3] APRA's *Monthly banking statistics*, issued 28 March 2013, and APRA's *Annual superannuation bulletin*, issued 9 January 2013.

40 The 'niche' nature of structured products is also reflected in the number of retail investors. By December 2012, according to Investment Trends,[4] there were approximately 32,000 investors in capital protected structured products in Australia—a significant decline from 45,500 in 2011 and 50,000 in 2010.

41 Table 1 compares trends in structured products with other alternative investments and retail derivatives up until December 2011. According to Investment Trends, 'capital protected products' were Australia's most popular 'alternative' in 2009, but dropped to a ranking of third among the 20 such products tracked by Investment Trends in 2010 and 2011. The research found that the demand for capital protected products dropped significantly following the global financial crisis, while some other alternative investments became more attractive. By December 2011, the top two products were listed investment companies and hybrid securities.

42 We can identify several contributing factors behind the slowdown in the market for 'protected' structured products:

(a) The financial crisis and its impact on some international investment banks and products created a challenging environment for structured products, globally.

(b) The present low-interest rate environment is unfavourable for 'bond plus call option' structures, with the relative high price of bonds leaving product issuers with less money to allocate to market exposure.

(c) Many products using the 'dynamic hedging' approach (explained in Section C) became fully allocated to cash or bonds during the global financial crisis, with no exposure to growth reference assets. While the products were designed to perform this way in a severe market downturn, the experience was often a negative and unexpected one for investors, particularly where they had borrowed to invest in long-term products.

43 However, certain high-yield and 'internally geared' structured products have increased in issuance, according to our review of recent PDS in-use notices. While the investor's outlay for these products is at risk of potential loss, the products are often promoted as offering a form of capital protection.

[4] Investment Trends defines 'capital protected products' as 'capital protected funds with a fixed duration'. This includes some structured products promoted as 'capital guaranteed', and excludes protected equity loans and warrants.

Table 1: Trends in the number of investors investing in complex products*

Period surveyed	Capital protected structured products	Contracts for difference (CFDs)**	Options (exchange-traded)	Futures
December 2011	45,500	44,000	28,000	8,000
December 2010	50,000	41,000	25,500	8,500
December 2009	52,000	32,000	34,000	13,500
November 2008	43,500	26,000	32,500	10,500
September 2005	–	9,000	–	–

* For a discussion of the reasons why investors acquire unlisted and unquoted structured products, see Section D.

** This refers to active CFD investors. Investment Trends estimates that the market share for listed CFDs remains very small in comparison to the OTC CFD market.

Source: Investment Trends, *Investor product needs report*, December 2011; and Investment Trends, *2012 Australia CFD report*, May 2012

Product issuers

44 There are four main types of issuers of unlisted structured products that are promoted as having 'capital protection' or a 'capital guarantee':

(a) investment banks;

(b) retail banks;

(c) medium and large non-banking financial services providers; and

(d) smaller product issuers, including SPVs.

45 Investment banks and retail banks dominate market share. In some cases, they can use several internal divisions when bringing a product to market. For example:

(a) the bank's structured finance arm may provide limited recourse loans to investors;

(b) the structured products division may arrange for the issue of the products;

(c) the derivatives trading desk may hedge its risks in the OTC market; and/or

(d) the same investment bank may or may not be the hedge counterparty.

46 Retail and investment banks may also market products directly to their retail customer base. Many have internal financial advisers. Alternatively, or in addition, they may have fully or partly owned adviser dealer groups that distribute these products.

47 Table 2 summarises the range of smaller 'boutique' companies offering structured products.

Table 2: Structured products issued by 'boutique' companies

Type of arrangement	How it works
White label arrangements	• Some boutique companies rebadge structured products issued by investment banks ('white labelling'). The boutique company may arrange for marketing and distribution of the product. • Distribution by the 'white labeller' may be direct to retail investors with personal advice provided, with general advice through seminars, or through networks of third-party financial advisers.
Special purpose vehicles (SPVs)	• Several small to mid-tier AFS licensees have set up ring-fenced SPVs to issue structured products. In several cases, these SPVs do not hold an AFS licence, but s911A(2)(b) of the *Corporations Act 2001* (Corporations Act) allows the appointment of an 'arranger' that holds an appropriate AFS licence under an 'intermediary authorisation' arrangement. The arranger may claim to have no ongoing obligation after the issue of the product. • While the financial product disclosure regime applies to unlicensed entities that issue financial products, there are other potential risks, including counterparty risks, for retail investors. SPVs that are not licensed by ASIC are not regulated to the same level as licensed entities. They are often small proprietary companies that do not have to lodge financial statements with ASIC, and may have little financial substance. AFS licensees, on the other hand, are required to have an adequate risk management framework and a cash flow projection for at least three months. • These factors mean that, if a product fails, retail investors may have a limited ability to recover funds due from an SPV product issuer. Investors may be reliant on the SPV to make adequate derivatives hedging, trustee and other arrangements to cover its obligations to investors, and, in turn, on counterparties' ability to honour their commitments. The hedge counterparties are generally investment banks.
Other business models	• The issuer of the structured product may be a thinly capitalised but wholly owned subsidiary of an investment bank. While the issuer's obligations to investors will typically be unsecured, the parent bank may or may not 'guarantee' these obligations, subject to certain qualifications, and the guarantee is likely to be unsecured. • The issuer may be established in an overseas jurisdiction that does not have equivalent financial services regulation or consumer protection provisions to those in Australia. Such entities may not be regulated by ASIC through the AFS licensing regime, and where the product is issued as shares under a prospectus, may not have membership of an external dispute resolution (EDR) scheme for investor complaints.
Third-party issuers	• Some investment banks and boutique product originators enter into agreements with third-party issuers, which provide responsible entity or product issuing functions. • However, the bank or boutique company's branding may be retained and promoted in PDSs and marketing materials, sometimes with more prominence than the branding of the entity that has issued the product.[5]

[5] Section 1013C(5) of the Corporations Act states that: 'The responsible person must not include a statement about the association between the financial product and a person if: (a) the statement creates the impression that the financial product is issued or sold by that other person; and (b) the person has not issued or sold the product'. Section 1013C(6) states that: 'A responsible person must not include a statement about the association between the financial product and a person if: (a) the statement creates the impression that the financial product is guaranteed or underwritten by that other person; and (b) the person has not guaranteed or underwritten the product'. Section 1013C(7) states that: 'If the Product Disclosure Statement states that a person provides, or is to provide, services in relation to the financial product, the Product Disclosure Statement must clearly distinguish between the respective roles of that person and the issuer or seller of the financial product'.

Business case for issuers

48 For issuers generally, structured products can be a way to generate profit and/or raise funds, as well as providing products and payoff features that may be attractive to investors.

49 Issuers’ margins (before costs) may vary widely, depending on the type of product or issuer. However, the complex nature of some derivatives-based products obscures their embedded costs for retail investors.

50 Some products may provide an opportunity for issuing banks to benefit from the difference between the price that retail investors are willing to pay to take on a particular risk, and the price of that same risk in the wholesale market. While issuer profit margins on these products are opaque and unclear, in some cases, they are sufficient to enable issuers to pay upfront commissions (a type of distribution cost) to financial advisers of up to 3–4% of the investor’s outlay.[6]

51 The margins may be higher in some products with embedded leverage, particularly where highly complex algebraic formulae are used to determine and describe the investor’s economic exposure and investment returns. For example, with some products, approximately 80% of investors’ outlay is used to buy call options that provide investment exposure to the reference assets, while approximately 20% comprises expenses and fees for the various parties involved in structuring and distributing the products.

Product distribution

52 The main distribution channels for OTC retail structured products are:

(a) product issuers’ internal financial advisers;

(b) advice licensees that are wholly or partly owned by product issuers;

(c) third-party advice licensees;

(d) ‘boutique’ companies that ‘white label’ products and arrange for their distribution; and

(e) direct sales by product issuers to retail investors.

53 Product issuers differ significantly in their use of these channels. For example, some retail banking product issuers rely mainly on sales by internal or employee financial advisers or staff. Other banking product issuers’ sales are divided between internal or vertically integrated adviser channels, and third-party advice licensees.

[6] Subject to the transitional provisions under the Future of Financial Advice reforms, from 1 July 2013 conflicted forms of remuneration such as these commissions will be banned. For more information, see Regulatory Guide 246 *Conflicted remuneration* (RG 246).

54 Product issuers that do not employ financial advisers and do not have ownership of financial advice groups tend to distribute mainly through third-party advice licensees, rather than relying on direct sales. Some boutique product issuers or promoters have also used direct marketing strategies and general advice seminars to attract retail investors. Some issuers directly market to existing investors when products are close to maturity, encouraging them to 'roll over' their money into a new product or tranche.

C Product analysis

Key points

Structured products promoted as 'capital protected' or 'capital guaranteed' vary widely in design, features, payoff features and asset class exposures. However, we have grouped the majority of these products into five broad categories—that is:

- bond plus call option products;
- limited recourse 'protected equity' loans;
- constant proportion portfolio insurance (CPPI) products;
- internally geared products; and
- capital-at-risk products.

There is potential for retail investor confusion as well as financial loss with some of these products, including those claiming to offer 'conditional' capital protection, products with compulsory borrowing, and certain products where leverage and investment exposure are created 'synthetically'.

This section describes the different types of products in the market, and specific areas of potential risk for retail investors. Readers already familiar with these products may wish to proceed to the following section.

Product overview

55 Structured product issuers employ various forms of financial engineering to offer investors exposure to the performance of markets or specific assets, often with some assurances about the return of their original capital at maturity.

56 Structured products promoted as having 'capital protection' or 'capital guarantee' typically combine a 'safe' and a 'risky' asset into one product structure. The safe asset, such as a bond, enables the issuer to promise the return at maturity of at least some, or all, of the investor's original outlay. This feature is promoted as the 'capital protection', or sometimes the 'capital guarantee'.

57 Meanwhile, derivatives such as options are used to create some level of 'participation' in the performance of equities, commodities or other assets. The participation rate varies and is influenced by prevailing interest rates, issuer fees and commissions, market volatility and product design.

58 While the investor's return is invariably based on the performance of specific reference assets (such as a basket of shares), the investor generally does not have ownership of these assets, with exposure to the performance of the reference assets achieved through derivatives. With such products, investors are not usually entitled to the dividends or franking credits that accrue to the

actual owners of assets such as shares. An exception is with limited recourse ‘protected equity’ loans, where dividends and franking credits accrue to the investor, who generally has beneficial ownership of the underlying shares: see paragraph 86.

59 This section gives a basic overview of the different types of capital protected or capital guaranteed structured products in the market, the building blocks used in their construction, typical payoff features, and investor benefits and risks.

60 We have included this product overview for two reasons:

(a) the products are complex and their internal workings and construction are often unclear from summary promotional material and PDSs; and

(b) an understanding of the products and their risks is required to assess whether they are being appropriately described and labelled.

Product design and features

61 Product design and features vary widely. For example, investors may receive a periodic income, investment returns may be capped, an investment loan or internal leverage may be available or even compulsory, and ‘participation’ may be more or less than 100% of the performance of the reference asset(s).

62 Gearing or leverage may increase the investor’s exposure to equity markets or other reference assets. With some products, this is achieved with a ‘protected’ loan, or through optional or compulsory borrowing that is embedded in the product structure.

63 Taxation considerations may drive investors (and their advisers) to certain capital protected structured products, particularly when borrowing or gearing is used. Borrowers may be able, or may be led to believe they are able, to claim tax deductions for some of their loan interest expenses or claim franking credits associated with distributions from underlying shares.

64 However, in some cases, there is uncertainty about the legitimacy of these strategies. For example, in a taxpayer alert issued on 14 June 2012, the ATO raised concerns about retail investors who claim franking credits and other tax deductions on certain ‘structured financial products that exploit franking credits and other tax benefits’.[7]

65 Structured products vary from short-term to long-term investments (approximately one to 10 years). Early redemption may be possible—however, break costs (based on the current ‘mark to market’ value of the embedded derivative), exit fees and a cancellation of the capital protection

[7] See ATO, *Structured financial products that exploit franking credits and other tax benefits*, taxpayer alert, 14 June 2012, www.ato.gov.au.

feature often apply. Some issuers only allow redemptions on a monthly basis and, in some cases, redemptions can take six to eight weeks.

66 Investors are exposed to the credit risk of the product issuer and potentially its hedge counterparties. Where derivatives are used, the hedge counterparty risk can have a number of levels:

(a) the product issuer may not hedge the product correctly or effectively because of flaws in its calculations or model (known as model risk);

(b) the investor may also be affected if the hedge counterparty is unable to fulfil its obligations; and

(c) investors may have no direct claim against the hedge counterparty, because they are not party to its contractual agreement with the issuer. This may cause complications if the issuer becomes insolvent.

Nature of capital protection or guarantee

67 While structured products are often promoted or labelled as having 'capital protection' or 'capital guarantee', the nature of this protection varies. It is important to distinguish these structured products from more conservative investments or products. Structured products differ in the following ways:

(a) They are not 'protected accounts' under the *Banking Act 1959*, and are not subject to the Australian Government Financial Claims Scheme ('deposit guarantee').

(b) They are not 'guaranteed annuities', which are provided by APRA-regulated entities.

(c) They are not 'capital guaranteed' superannuation funds, as defined by the Corporations Act. For a public offer superannuation fund or a retirement savings account (RSA), the Act defines 'capital guaranteed' as meaning that 'the contributions and accumulated earnings may not be reduced by a negative investment return or a reduction in the value of an asset in which the product is invested'. The promise of capital security, for superannuation funds or RSAs, is made by a prudentially regulated entity.

68 Structured products, and the protections or guarantees they offer, are often an unsecured promise by the product issuer or capital protection or guarantee provider. From the perspective of the issuer—typically, but not always, a retail or investment bank—this debt obligation usually ranks equally with its other unsecured obligations and debts, other than liabilities mandatorily preferred by law (e.g. bank deposits and covered bonds).

69 Retail investors rely on the creditworthiness of the product issuer and its hedge counterparties, but may rank behind secured and preferred creditors if the issuer becomes insolvent.

70 Capital protection, when provided, is usually in nominal terms and does not adjust for the time value of money. In real (inflation-adjusted) terms, investors may lose money even when capital is protected.

71 The PDS generally describes the conditions under which capital protection may be cancelled, including 'early termination' events that are outside the retail investor's control. Capital protection only applies for products held until maturity, and may expire if products are held by the investor after their maturity date.

72 In leveraged products, using limited recourse loans and 'internal gearing', the investor's outlay of loan fees and interest is generally not protected—that is, it will not be returned to the investor if the reference assets do not perform sufficiently well. However, the principal amount of the investment loan is generally limited recourse. This means that the lender does not usually have recourse to other assets of the investor, but may be able to keep the underlying or reference assets if the borrower (investor) defaults on their obligations.

Product types

73 Structured product issuers employ a potentially limitless variety of product designs, payoff features and investment exposures. It is unusual to find two identical products—making direct comparisons difficult for investors. Structured products can be designed to meet specific investors' needs and are sometimes referred to as 'bespoke' or 'tailored' investments.

74 We have categorised structured products offering some form of capital protection or guarantee into five broad types. We believe this covers the majority of the OTC structured products within this scope of this report that are marketed to retail investors in Australia.

75 These product types are:

(a) bond plus call option products;

(b) limited recourse 'protected equity' loans;

(c) constant proportion portfolio insurance (CPPI) products;

(d) internally geared products; and

(e) capital-at-risk products.

76 These products take various legal forms, including deferred purchase agreements, managed investment schemes and shares. Table 3 compares the features of each product.

Table 3: Comparison of structured products promoted as 'capital protected' or 'capital guaranteed'

Feature	Bond plus call option	Limited recourse 'protected equity' loan	CPPI	Internally geared	Capital-at-risk
Term (typical)	3–10 years	3–5 years	5–8 years	2–5 years	1–5 years
Risk of not breaking even/losing money[8]	With no borrowing: No With borrowing: Yes	Yes	With no borrowing: No With borrowing: Yes	Yes	Yes
Method of capital protection	The bond's value at maturity equals the initial investment	Loan interest and fees are not protected. The loan is limited recourse at maturity	The bond's value at maturity equals the initial investment	Loan interest and fees are not protected. The loan or 'notional exposure' may be limited recourse at maturity	Not applicable. Maturity value typically linked to the worst performing reference share, if a barrier event occurs
Potential investor benefits	Potential tax deductions (geared investors) Return of capital at maturity (subject to issuer creditworthiness) Potential income/growth from reference assets	Potential tax deductions Dividends and franking credits Leveraged exposure to positive share performance	Potential tax deductions (geared investors) Return of capital at maturity (subject to issuer creditworthiness) Potential income/growth from reference assets	Potential tax deductions with some products Potential income/growth from reference assets	High yield Capital return in sideways and moderately declining markets (subject to issuer creditworthiness)
Key investor risks	Counterparty risks Product complexity Perception of equivalence with bank deposits Early maturity events	Counterparty risks Product complexity May not break even—reference asset growth must exceed net borrowing costs	Counterparty risks Product complexity Perception of equivalence with bank deposits Leverage Potential for cash-lock in some leveraged products	Counterparty risks Product complexity May not break even—reference asset growth must exceed net costs Tax risks (some products) Limited participation Leverage	Counterparty risks Product complexity Yield may underprice the risk Potential for capital loss Risk of worst performing reference asset Perception of equivalence with bank deposits

[8] This assumes the creditworthiness of the issuer and counterparties at maturity, and the absence of early maturity events, and ignores the impact of inflation. All of these products are subject to reference asset or market performance risk, and time value of money risk.

Bond plus call option products

77 For bond plus call option products, the majority of the investor's money is usually placed in a safe asset, such as a zero coupon bond. Most of the remaining money is typically invested in derivatives, such as call options, to gain exposure to the performance of riskier assets such as a basket of shares.[9]

78 Zero coupon bonds are bought for less than their face value and do not pay interest (coupons) during their term. As long as the issuer does not default, the principal amount invested is returned to the bondholder at maturity.

79 The proportion of investors' money that is allocated to the safe (bond) and risky (call option) parts of these products depends on prevailing interest rates and bond values, volatility in the reference assets, the investment timeframe, and fees and/or commissions.

80 A low-interest environment tends to reduce the attractiveness of the bond plus call option structure, because more money needs to be allocated to the bond to ensure capital protection at maturity, leaving less money exposed to the performance of other assets (another option would be to lengthen the investment term, which may not be attractive to investors).

81 Product design and the type of reference assets vary widely. For example, a yield or income may be provided, investment returns may be capped or limited, a loan may be available, and participation may be more or less than 100% of the performance of the reference assets. In rising markets, or when underlying trading is profitable, some products also allow for increases in the protected amount by periodically 'locking in' a portion of the trading profits during the investment term.

Example: Bond plus call option product

Figure 1 shows an example of a bond plus call option product.

ABC Bank offers an investment with a five-year term, performance linked to the S&P/ASX 200 index, and with capital protection at maturity. Taking into account interest rates and market conditions, the issuer allocates investors' money as follows (represented by the column on the left of the diagram):

- zero coupon bond (70%);
- five-year call options over the Australian share index (25%); and
- product issuer fees and adviser commissions (5%, upfront).

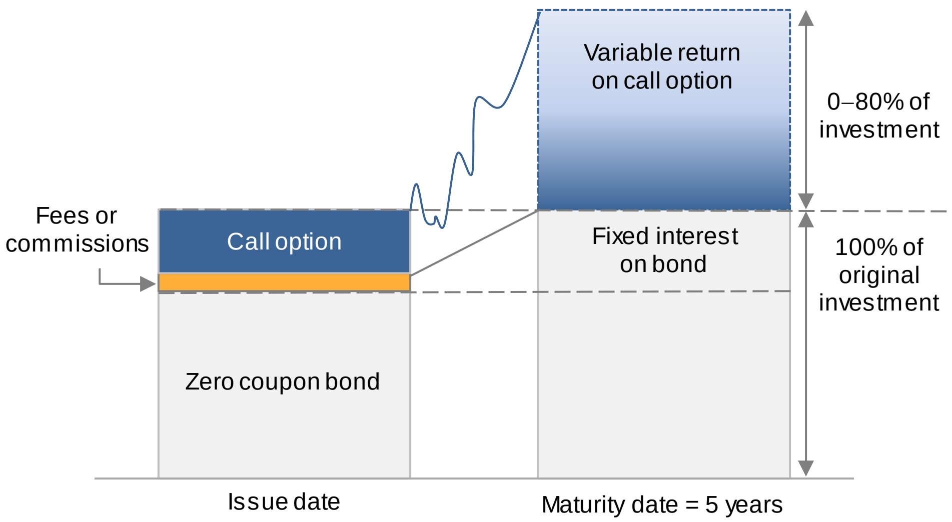
[9] Some structured products may embed 'binary' or 'digital' options. Similar to bond plus call option structures, they use the bond to generate interest. This interest is used to purchase the binary options to gain 'all or nothing' exposure to the performance of reference assets. At maturity, the investor may receive their original capital investment (subject to counterparty risks) as well as the payoff, if any, from the binary option. In the 1990s, these products were often sold as providing return of 2% (minimum) to 10% (maximum), when interest rates were approximately 5%. At maturity, interest of 3% earned by the bond was used to buy the binary option that paid 8% under certain reference asset performance conditions. At best, this structure could provide the investor with a 10% return at maturity, or otherwise a 2% return, plus their original capital.

By maturity (the column on the right), the value of the bond will at least grow to the value of the investor's original contribution, providing at least the return of capital at maturity (in nominal dollars, and subject to the bank's financial ability to pay). In 'real' terms, assuming an average annual inflation rate of 3%, an investor would want to receive at least $115,927 on an original investment of $100,000, at the end of five years to keep pace with inflation.

A profit is also possible, depending on the S&P/ASX 200 performance, because the value of the call options may increase (see 'variable return on call option' on the right side of the diagram). In this example, investment returns are capped at 80% (even if the market performs better than that).

Because the product issuer may not buy the underlying shares that comprise the share index, investors do not have the benefits of share ownership, such as dividends and franking credits.

Figure 1: Example of bond plus call option product performance



Note: This chart is based on the hypothetical example described above. The call option returns are variable and uncertain, and may be zero. Returns are capped at 80% in this example.

Source: ASIC

Conditions on the protection or guarantee

82 Return of the investor's capital at maturity is subject to the product issuer's ability to pay (its creditworthiness) and may also be subject to the performance of other counterparties or entities involved in the structure. Retail investors are usually unsecured creditors, ranking behind secured creditors and bank depositors (if the issuer is a bank) if the issuer becomes insolvent.

83 Protection only applies at maturity. Investors withdrawing early may not receive the return of their original investment, because exit fees are charged to cover the issuer's costs in unwinding its hedging arrangements.

84 Other clauses give the issuer the right to terminate an investment before maturity if an 'early termination event' occurs. This also cancels the capital

protection. Such events may include legislative or taxation changes, market disruptions or other events outside investors' control. For example, some issuers state that they may unwind the product early (cancelling capital protection) if their business and hedging costs rise materially.

85 Some bond plus call option products are described as 'capital guaranteed', where a third-party bank (an Australian ADI) is named as the capital guarantee provider. However, the investor may not have the same security as a bank depositor. The guarantee is generally an unsecured obligation of the bank.

Limited recourse 'protected equity' loans

86 'Protected equity' loans offered by banks allow retail investors to finance some or all of their purchase of assets—often S&P/ASX 200 shares. The loans usually have a set term, such as three or five years. They are typically interest only, and interest may be prepaid annually in advance by the borrower. As well as loan interest, investors may have to pay for put options, which create a floor beneath which the value of the reference assets cannot fall.[10]

87 Interest payments may be tax deductible, subject to the capital protected borrowing and prepayment provisions in taxation law. Division 247 of the *Income Tax Assessment Act 1997*[11] defines 'capital protected borrowings' and 'capital protection' for tax purposes, and to ensure that capital protection provided under a relevant capital protected borrowing, to the extent that it is not provided by an explicit put option, is treated (for the borrower) as if it were a put option. Division 247 sets out a methodology for reasonably attributing the cost of capital protection obtained by a borrower under a capital protected borrowing.

88 Because the loans are limited recourse, the investor's worst-case scenario is also limited. The loans are often promoted as suitable for self-managed superannuation funds (SMSFs), which are allowed to borrow as long as the lender will not have recourse to other assets of the fund in the case of default.

89 The product issuer (lender) takes a mortgage over the underlying shares, and can keep them if the investor defaults on loan interest payments. However, while the shares are typically held by the issuer or trustee, the investor enjoys the benefits of owning them (i.e. share dividends and franking credits).

---

[10] Put options give the buyer of the option the right, but not the obligation, to sell selected assets at a predetermined price before or at a certain date. By buying the underlying asset (e.g. shares), and also buying put options as protection, investors and structured product issuers can create a floor on the value of an investment portfolio. Counterparty credit risk still applies (i.e. the risk that the seller of the put option defaults). This risk can be mitigated by buying exchange-traded put options.

[11] Section 247.10 of the *Income Tax Assessment Act 1997* defines 'capital protected borrowings' and 'capital protection' as:

(1) An arrangement under which a borrowing is made, or credit is provided, is a capital protected borrowing if the borrower is wholly or partly protected against a fall in the market value of a thing (the protected thing) to the extent that:
(a) the borrower uses the amount borrowed or credit provided to acquire the protected thing; or
(b) the borrower uses the protected thing as security for the borrowing or provision of credit.

(2) That protection is called capital protection.

90 At the end of the loan term, investors can choose to repay the loan and take ownership of the underlying shares. They may also direct the product issuer to sell the shares and use the proceeds to repay the loan. If the shares are worth more than the loan amount outstanding, the investor receives the difference (after brokerage and other fees). If the share performance was poor and did not result in growth, the shares are returned to the product issuer or lender at maturity and, because the loan is generally limited recourse, the investor has no further liability.

91 For the retail investor to profit from investing with a protected investment loan, the underlying shares or other assets must appreciate sufficiently to cover the interest costs, put option premiums and other fees. However, this break-even hurdle is lowered by any dividends and franking credits that the investor receives (as the beneficial owner of the underlying shares) and tax deductions claimed.

92 PDSs describe the conditions under which capital protection may be cancelled, including early withdrawal by the investor (loan break fees would also apply). However, the lender or issuer may also cancel the capital protection or require that the loan is repaid early if certain events occur, including legal changes, market disruptions or other early termination decisions made at the lender's or issuer's discretion.

Size of the protected lending market

93 Figure 2 shows the trends in protected loans issuing by banks and brokerage firms that offer margin lending facilities, based on data from the quarterly survey by the Reserve Bank of Australia (RBA). The RBA quarterly survey defines 'margin lending' and 'protected financing' as follows:

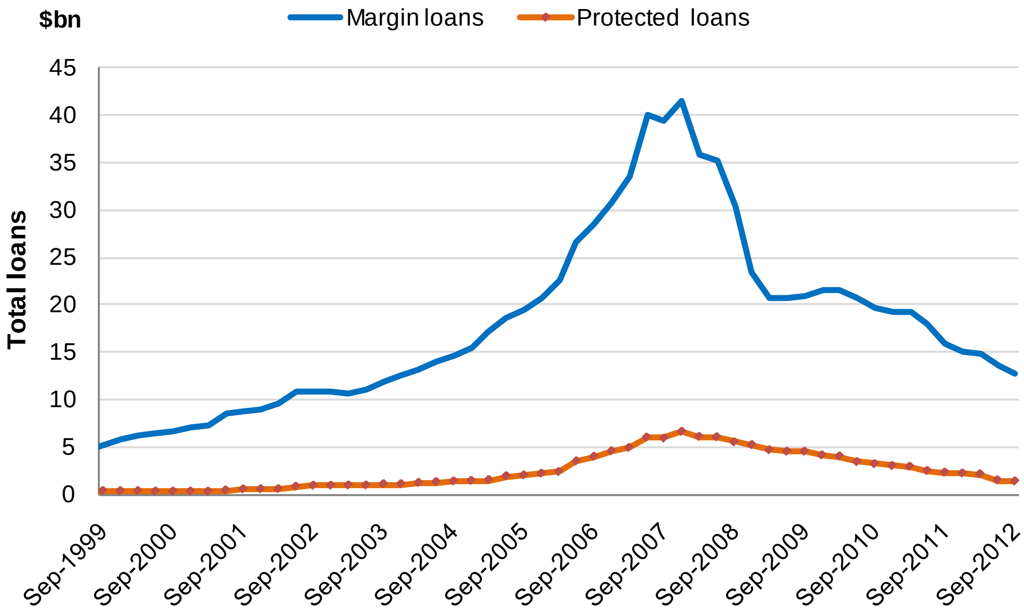
(a) *Margin lending* refers to the aggregate value of outstanding loans that are backed by approved securities (usually Australian equities and managed funds). The 'value of underlying security' is the market value of all security backing the margin lending at the end of the quarter.

(b) *Protected financing* (i.e. protected lending) refers to margin loans packaged with a derivative product, which guarantees that the portfolio's capital value does not fall. Lenders typically charge a higher rate of interest for providing a capital protection facility.

94 An important distinction between margin loans and protected loans is that borrowers with protected loans do not receive margin calls.

95 The protected lending market peaked in December 2007 at $6.3 billion, or 15.9% of all margin lending. By December 2012, the value of protected loans was $1.28 billion, or 10.5% of all margin lending.

Figure 2: Margin loans and protected loans, 1999–2012



Source: RBA statistical table D10, 'Margin lending'

Constant proportion portfolio insurance products

96 In the mid- to late-2000s, a wave of 'constant proportion portfolio insurance' (CPPI) structured products were issued. Many of these had terms of seven to eight years, maturing between 2012 and 2016.

97 As with the bond plus call option structure, CPPI products have exposure to the performance of a combination of safe and risky assets, aiming to provide the investor with simultaneous capital protection (at maturity) and synthetic market exposure through derivatives.

98 The proportion of money allocated to safe and risky assets automatically changes depending on the reference asset or market performance (also known as 'dynamic hedging'). For example, allocation to shares might increase when the prices are rising, while allocation to bonds increases when markets fall, so that the product provider can at least return the investor's original nominal investment at maturity.

99 The product's payout depends on the path taken by the risky asset:

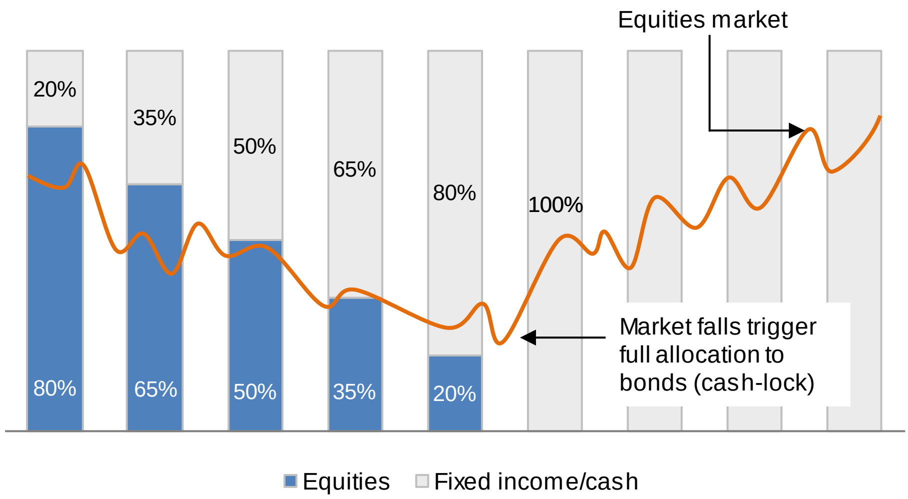
(a) When markets rise strongly, CPPI products may provide higher returns than other types of 'capital protected' structured products, because more money participates in the risky asset's performance. However, these returns may be lower than similar 'unprotected' risky assets (e.g. simply buying the reference shares), because the cost and fees for protection may have a 'drag' effect on performance.

(b) When markets are flat or decline, CPPI products are designed to return at least the original investment at maturity in nominal terms.

(c) When markets fall dramatically, money is shifted to the risk-free asset, to ensure the return of the original capital at maturity. However, the product may remain allocated to bonds or cash even if markets or the underlying reference assets begin to recover during the investment term. This means that investors would not participate in the recovery—a common experience following the 2007–08 market events. Figure 3 gives a graphical representation of this kind of scenario, which became known as 'cash-lock'. (See also paragraphs 102–104.) A further risk in this scenario is that investors are selling into a falling market, which is contrary to the basic investment principle of 'buying low and selling high'.

(d) The payoff for CPPI products is highly 'path dependent', or influenced by the pattern of price changes in the reference assets. Path-dependent payoff structures are by nature highly unpredictable. Even if a retail investor thinks they know how the underlying reference asset may perform in the future, they will be unable to estimate the CPPI product's performance with any confidence.

Figure 3: CPPI allocations to risky and low-risk assets



Note: This is a stylised representation to illustrate changes in the relative allocations to bonds and derivatives. Outcomes are highly path dependent.

Source: ASIC

Borrowing in CPPI products

100 As with other structured products described in this report, CPPI products may be sold with either optional or compulsory borrowing or leverage, where retail investors can borrow the principal amount to be invested. If there is borrowing, the investor's outlay is the interest and fees for the investment loan, and an embedded or explicit put option fee to create protection.

101 In return, investors get investment exposure equivalent to the principal amount of the loan. In the past, some of these loans have been full recourse, meaning that investors who defaulted on their loan interest or put option payments could lose any capital protection, and the lender potentially had full recourse to the borrower for the repayment of any outstanding loan amount, fees and break costs.

The global financial crisis and ‘cash-lock’

102 Following the onset of the global financial crisis, the asset allocation in many Australian CPPI products shifted entirely to bonds, with no exposure to growth assets. This mechanism was triggered to ensure that the products achieved ‘capital protection’ at maturity.

103 However, because product issuers were obliged to at least provide capital protection at maturity, money could not be reallocated to shares when markets started to recover.

104 Where investors had borrowed to invest in CPPI products, the consequences were the most detrimental. Some of these products had terms of seven to eight years until maturity, with exit fees applying to early redemptions. Fully geared investors whose products went into cash-lock were required to continue paying the interest on their loans, while they had little or no chance of a positive return at maturity: see Case study 1 below.

105 Some retail investors in CPPI products that were cash-locked may not have realised that they would not receive any return at maturity, that all of their outlay (fees and loan interest) had effectively been lost, or that they may have been better off paying an exit fee to terminate their investment loans. Qualitative consumer research commissioned by ASIC, and detailed in Section D, gives some examples of retail investor confusion and financial loss in relation to these products, as well as poor financial advice.

Case study 1

In the mid-2000s, an investor invested in a product described as ‘capital protected’ on the recommendation of their financial adviser. While it wasn’t clear to the investor at the time, all of their outlay was interest and fees for a ‘notional’ $100,000 loan, which was to be invested in bonds and shares. The outlay was not capital protected, but the product included put options. This meant that, if the investments lost money, the investor wouldn’t be liable for the losses (and wouldn’t have to repay the principal amount of the loan) as long as they kept paying the loan interest and fees until maturity.

The investor paid approximately $8,000 each year in loan interest, plus $800 for put options to provide capital protection. They were told by their adviser that 80% of the interest payments were tax deductible and that, if they maintained the $8,800 annual payments, the investment would be worth ‘half a million dollars’ by maturity.

Several years into the arrangement, share markets plummeted and the money in the CPPI product was transferred to bonds to protect the maturity value of the $100,000 loan. This meant there was no possibility that the notional investment would be worth more than the $100,000 needed to repay the loan at maturity, so the investor could no longer expect any returns. By maturity, the interest and fees they had paid would be over $70,000, less the tax deductions claimed.

'It was a disaster of mammoth proportion,' the investor said. 'We took this option out seven years ago, it [had] an eight-year maturity, we put in $8,000 a year … and we paid for put options so if things went pear-shaped [our money] would be 'put' in the bank. I thought there would be ups and downs but I always wanted some sort of protection in there for the lower times.'

The investor didn't realise that the interest and fees they were paying weren't capital protected and that they would not receive any money at maturity. 'None of this was explained to us at all, it was explained to us that at the very worst we would get our money back. But the misunderstanding was that you will get your money back to pay your margin loan so you won't have a debt. Whereas our interpretation was we will get our money [back] that we personally invested each year.'

The investor received many statements from the product issuer but found them difficult to understand. Their adviser suggested paying an exit fee and transferring their money to a 'recovery product', which also ended up going into cash-lock. 'We deliberated on that quite a lot and decided not to take it [up], because we figured we had better cut our losses and [we] couldn't trust [the adviser] again to get it right.' [12]

Internally geared products

106 Limited recourse 'protected equity' loans (as described in paragraphs 86–95) can be relatively expensive for retail investors, because of the costs of loan interest and put options. This is one factor that led to the development of 'internally geared' structured products, some of which purport to offer some of the benefits of protected loan structured products, such as leverage, capital protection and potential tax deductions.

107 When the product issuer does not purchase or hold the underlying reference assets (e.g. shares), retail investors will not receive the associated dividends and franking credits. However, an income or coupon is often paid as part of the structured product design.

108 Two types of internally geared structured products are available, although it is difficult for retail investors to tell them apart:

[12] This case study is adapted from the qualitative research report produced by Susan Bell Research, Report 341 *Retail investor research into structured 'capital protected' and 'capital guaranteed' investments* (REP 341), which is available on the ASIC website at www.asic.gov.au/reports.

(a) where the loan is 'real'—that is, actual money changes hands between a lender and a structured product issuer. The lender and product issuer may be part of the same banking group; and

(b) where the loan amount is 'notional', with leverage and investment exposure created 'synthetically' through derivatives such as call options.

In both cases, the investor's outlay is not capital protected.

109 If the investor wishes to exit these products before maturity, the principal amount of the loan, or a portion, may have to be repaid, in addition to break fees. Other similar products offer an annual 'walk-away' feature which allows early exit.

110 The payoff profile for these products often resembles that of call options. Where the leverage is created synthetically (through derivatives), the investor's outlay effectively funds the derivative premiums.

111 At maturity, the retail investor should generally be entitled to the change in value of the reference assets that they have bought exposure to. However, their participation rate varies, depending on a range of complex factors, including the price and volatility of the call options and other hedging arrangements.

112 A deferred purchase agreement structure is often used, where investors may elect at maturity to repay the principal amount of the notional loan and, in return, receive delivery of shares, which are often different to the reference assets that determine the product payoffs. Alternatively, an investor may choose for the product issuer to sell the delivery shares to repay the loan, with the investor being entitled to the difference between the original loan amount and the reference asset appreciation. If the assets have depreciated in value, the investor may not receive any returns at maturity.

Labelling and description concerns

113 While these products are often labelled, described or promoted as 'capital protected', the investor's outlay is at risk of loss.

114 Only the principal amount of the loan or the notional investment exposure is protected, and only in the sense that it will not have to be repaid by investors who remain in the product and maintain any interest and fee payment obligations until maturity.

115 In addition, we are concerned that it may be misleading or deceptive to describe certain 'synthetically geared' products as entailing a loan and loan interest payments, if the product does not entail a 'real' loan but offers leveraged exposure created through derivatives, especially if this is not explained.

Tax advantages/deductibility

116 One of the chief potential benefits of some internally geared products is investors' ability to claim tax deductions for a portion of their interest expenses. This reduces the cost of the investment exposure and increases the likelihood of breaking even or making a profit.

117 However, when the main economic rationale for a product appears to be tax deductibility, there is a risk that the ATO may view the product as a tax avoidance scheme, particularly if investors could achieve a similar benefit (apart from the tax deduction) by purchasing other financial instruments such as call options.

118 In such cases, there are potential risks for retail investors who claim tax deductions where the product has not been subject to a favourable ATO product ruling. If such deductions are disallowed, investors could face the repayment of deductions, as well as penalties and interest. The ATO issued a public warning to retail investors in June 2012, through a taxpayer alert, which highlighted the potential risks in claiming tax deductions and franking credits with certain structured financial products.[13]

Capital-at-risk products

119 Structured 'capital-at-risk' products, described in the industry using terms such as 'reverse convertibles', are often promoted as having a 'contingent' or 'conditional' capital protection. They generally pay investors a fixed annual return that exceeds the average yield of most other asset classes. Distributions can range from approximately 10% to over 20% per year.

120 In return for this high yield, investors take on the risk that they will lose some or even all of their capital in a worst-case scenario. The capital return (and sometimes the yield) is usually tied to the performance of a basket of reference shares or other assets, so that in adverse market conditions, the risk profile of the structured products becomes similar to that of the reference assets.

121 The yield from reverse convertibles depends on a range of factors, including the number, type and volatility of the reference assets chosen. Where market volatility is high, the price of put options, which are central to the reverse convertible structure, will also be high, and so the yield paid to investors should be high too. However, this high volatility also increases the likelihood that the product's reference assets will fall below a level that triggers a potential capital loss. The yield offered to investors (and the risk of capital loss) may be further increased by the inclusion of a greater number of reference assets and/or more volatile reference assets.

[13] See ATO, *Structured financial products that exploit franking credits and other tax benefits*, taxpayer alert, 14 June 2012, www.ato.gov.au.

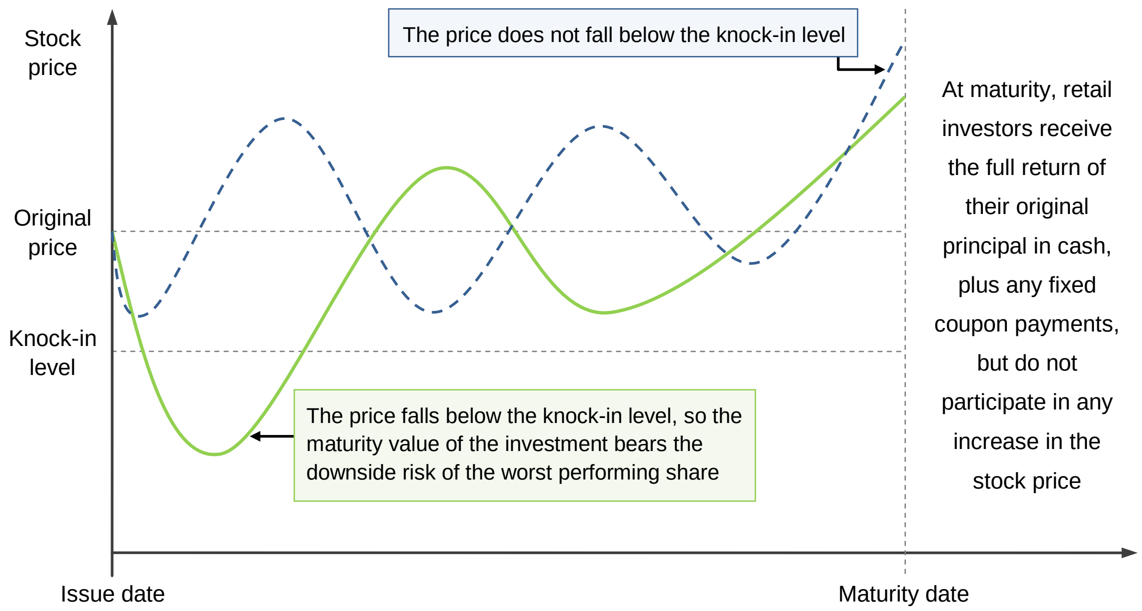
122 An example is the 'worst of knock-in' reverse convertible. If the price of any of the reference shares falls below a predetermined trigger price—often known as a 'barrier' or 'knock-in' event (e.g. a share price drop of 30–40%)—investors receive, at maturity, a return equivalent to the closing price of the *worst* performing share in the reference basket.

123 If the barrier event is never triggered, investors generally receive, at maturity, 100% of their initial investment (as well as the income payments), subject to the creditworthiness of the product issuer. In some cases, whether the price has breached the barrier is only observed at maturity (a 'European knock-in'), or at predetermined observation dates (e.g. annually at each anniversary of the product's commencement). If the barrier is active from transaction date until maturity, it is an 'American-style knock-in'.

124 When a barrier is breached, the potential capital losses can be significant. For example, a recent product paying a yield of up to 17% per year 'knocked in' when one of its reference shares breached the barrier level, subsequently losing approximately 70% of its value by maturity. The product was described by the issuer as having 'conditional protection'.

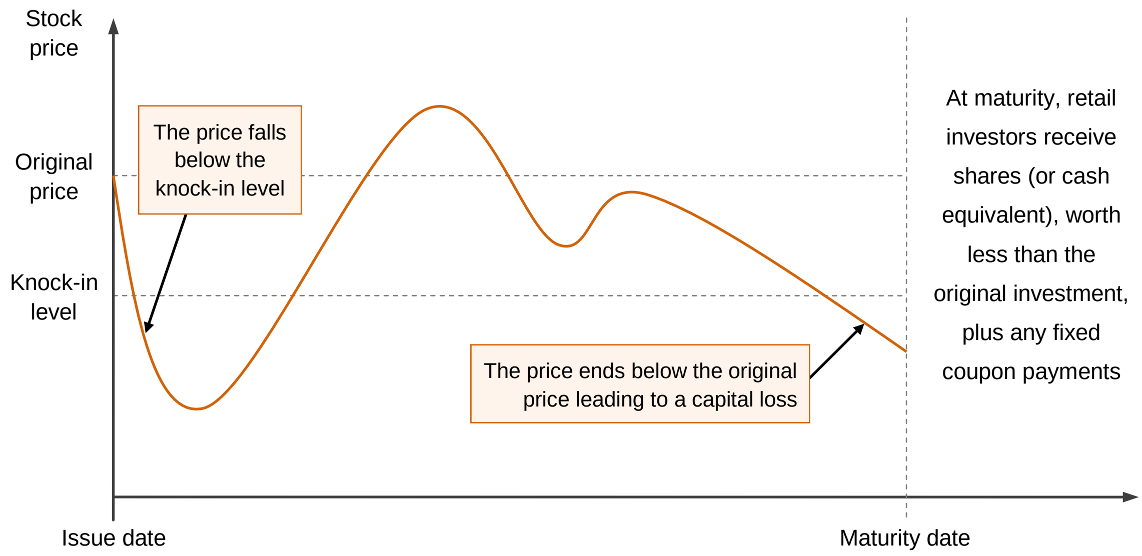
125 Figure 4 illustrates an example of a reverse convertible linked to the performance of two reference shares, which are represented by the blue (dotted) and green (solid) lines. The price of the blue share never falls below the knock-in level, but the price trend of the green share does cause the underlying option to 'knock in'. Fortunately, in this example, the price of each share finishes above its starting point, despite the green share having fallen below the knock-in price. The value of the capital returned at maturity is therefore the original investment.

Figure 4: Reverse convertible—Positive scenario



126 Figure 5 shows an example of a reverse convertible with just one reference share. In this example, the investor loses capital because the share price falls below the knock-in price and, at maturity, ends up at less than the starting price of the share.

Figure 5: Reverse convertible—Negative scenario



Labelling and marketing

127 Reverse convertible products are often labelled, described or promoted as having 'conditional', 'contingent' or 'limited' capital protection, because the initial investment should be returned if a barrier event does not occur. We consider this practice may be inconsistent with the risky nature of these products and, as a result, may be potentially misleading or deceptive for investors. Reverse convertibles generally offer equity-like risks on the downside.

128 Labelling or describing reverse convertibles as 'capital protected' may attract retail investors seeking yields higher than those available from bank deposits. In some cases, product advertising compares these products and their returns to bank deposits.

129 Structured capital-at-risk products became particularly popular in parts of Europe, Asia and the United States in the last decade as retail investors searched for higher yield in a low interest-rate environment. However, in some cases, retail investors mistook the risks of these products as equivalent to bonds or cash deposits.

130 As a result, several national regulators have taken action in relation to the regulation and/or labelling of these products. For example:

(a) In the United Kingdom, these products are known as 'structured capital-at-risk' products (SCARPs). In 2005, the Financial Services Authority (FSA) reported on widespread mis-selling of these products, later obtaining approximately £159 million in compensation for consumers. In 2009, the FSA reported that:

> We have seen promotions where the risk is described in terms of 'contingent protection' or similar language. Describing a risk in term of 'protection' or using a double negative can obscure an important risk warning. This is made worse if there is a clear and prominent claim of 'capital security', and a less prominent and insufficient explanation of when capital can be lost. In our view, it is unfair, unclear and misleading to describe SCARPs as 'safe' or 'secure'. This description also undermines the message that capital can be lost … the same applies to the term 'protected', unless the limits of the 'protection' are very carefully explained.

(b) In Belgium, where there is a voluntary moratorium on the sale of 'particularly complex' structured products to retail investors, reverse convertibles are considered particularly complex when the protection built into the product is conditional.

(c) The Monetary Authority of Singapore (MAS) has prohibited the use of the term 'capital/principal protected', and any other derivative of this term (which would include 'conditional' capital protection), in the name and description of a collective investment scheme. The prohibition applies to all disclosure documents and advertising materials for offers of capital markets products. The objective is to prevent investors from mistaking products that may be capital/principal protected as being 'capital/principal *guaranteed*', which has a different meaning.

131 Several product issuers in Australia have differentiated themselves from competitors by describing these products as unsuitable for investors who are seeking capital protection, and prominently stating that investors' capital is at risk. We consider this approach is more likely to inform investors of the nature of the product. We are writing to those issuers who have not already adopted this practice, to seek appropriate changes.

Opaque pricing

132 It can be difficult for most retail investors to assess whether the yield on the products is a fair return for the risks being taken. Embedded securities and derivatives can obscure commissions and fees. Competition between providers and products does not solve this problem, because to compare yield on a like-for-like basis would require identical products with the same reference assets, timeframes and issuer credit risk profiles to be issued at the same time. This rarely happens.

133 Overseas studies[14] of the pricing of similar products have alleged systematic underpricing of risk (i.e. retail investors are being insufficiently compensated

[14] For example, Carole Bernard, Phelim Boyle and William Gornall—in their paper, 'Locally capped investment products and the retail investor', undated, electronic copy available at: http://ssrn.com/abstract=1101796—find that 'locally capped products' are overpriced by an average of 6.5% when sold publicly. Marta Szymanowska, Jenke Ter Horst and Chris Veld—

for their risk of capital loss). Further, in the United States, the Financial Industry Regulatory Authority (FINRA) issued an 'investor alert' on reverse convertibles, describing them as complex and risky investments that do not offer principal protection. The regulator states that issuers 'charge an up-front embedded fee to investors—typically ranging from less than 1% to 8% or more—for assembling and packaging a reverse convertible's individual components'.

134 For product issuers, reverse convertibles may effectively provide a cheap way to buy protection (put options) from retail investors, or a way to profit from the difference between the wholesale market price for put options and what retail investors will pay. However, retail investors have limited exposure to the performance of the reference shares if prices rise, but all of the downside risk of exposure to the reference share prices in a falling market, often concentrated to the worst performing reference share.

Case study 2

A term deposit account holder with a bank, and a trustee of their own self-managed superannuation fund (SMSF), had spoken to a financial adviser from the bank about a capital protected product that was paying a return of over 8% per year. The investor was attracted by the yield, which was better than the bank's term deposit rates, and what they understood to be the capital preservation. 'The driving force behind [looking at these products] is to try to maximise my return on the super fund investments,' the investor said. 'But the overriding consideration is the preservation of capital. In theory these sort of products will yield a better rate of return than term deposits but hopefully will be capital secure.'

The investor tended to invest their SMSF money primarily in term deposits and cash, and identified as a cautious investor. 'I have sufficient resources and funds for my retirement as long as I don't muck it up,' they said. 'As long as my investments do not lose capital, I think I will have enough money so I don't need to chase high returns to survive.'

When the investor looked at the product in detail, they discovered that, despite the 'guaranteed interest rate' and 'capital protection', their capital would only be secure if none of the underlying shares fell by 40% or more. They were also suspicious about how the returns were generated, and found that the adviser could not explain the product to them. 'I don't think they knew in detail how the product works,' the investor said. They also found that 'the fees are not transparent to anybody who buys the product'. The investor chose not to invest for these reasons.[15]

in their paper, 'Reverse convertible bonds analyzed', 2008, electronic copy available at: http://ssrn.com/abstract=730543—find that Dutch 'plain vanilla' and 'knock-in reverse convertible bonds' are, on average, overpriced by almost 6%.

[15] This case study is adapted from REP 341.

D Investor research

Key points

This section looks at the type of retail investors using 'capital protected' or 'capital guaranteed' structured products, their motivations for doing so, and their experiences with these products.

High net worth individuals, and those who may benefit from tax deductibility of interest payments, have often been attracted to these products, but investors span a range of consumer demographics.

Most people invest in structured products for capital protection, leverage, potentially high returns or tax deductions—or a combination of these factors.

Qualitative consumer research commissioned by ASIC has identified a range of issues relating to retail investors and these products, including a lack of understanding of the risks and the nature of the capital protection or guarantee.

135 This section draws on investor research from two sources with different samples and research objectives:

(a) qualitative research by Susan Bell Research, commissioned by ASIC in 2011. This entailed in-depth interviews with 25 people who had invested in, or were considering investing in, structured products promoted as having some form of capital protection or capital guarantee. This section summarises some of the key findings of that research—for more details, see Report 341 *Retail investor research into structured 'capital protected' and 'capital guaranteed' investments* (REP 341), which is available on the ASIC website at www.asic.gov.au/reports; and

(b) market research and data published by Investment Trends.

Profile of retail investors

136 Research in 2011 by Investment Trends looked at the typical profile of retail investors in structured products that it defines as 'capital guaranteed funds with a fixed duration'. It found that:

(a) the median age of the structured product investors surveyed was 56 (older than the median age for all Australians, which was 46);

(b) more than half (56%) of the investors were 55 years or older, 30% were aged between 40 and 54, while just 14% were aged under 40 years;

(c) investors tended to be male;

(d) 28% of the sample invested through an SMSF; and

(e) 67% of respondents had a financial adviser, 56% stated that their adviser had played a role in their most recent investment in these products, and 44% stated that they had learned about their most recent investment in a capital protected product through an adviser.

137 Separate qualitative research on behalf of ASIC by Susan Bell Research, while not intended to be statistically representative of all retail investors in these products, included investors in capital protected or capital guaranteed structured products at different life stages, with the products appealing to a wide cross-section of retail investors. These included:

(a) young singles, looking for a ‘starter’ or ‘entry-level’ investment;

(b) couples with children and a mortgage, looking for ways to get ahead;

(c) people who had been made redundant and were looking for somewhere to invest a redundancy package;

(d) pre-retirees and retirees seeking to diversify their investments;

(e) retirees seeking an income in retirement; and

(f) people investing through an SMSF and ‘directly’.

138 In summary, while many retail investors are relatively wealthy, there is some diversity in the wealth, investible assets, age and life stage of investors.

Motivations for investing

139 This section includes findings and extracts from the qualitative research report by Susan Bell Research, REP 341.

140 Participants in the research were mainly motivated to invest in capital protected or capital guaranteed structured products to achieve protection from loss, and to achieve investment growth. All investors in the sample expected these outcomes. For some investors, these products were also expected to deliver:

(a) easy ‘set and forget’ investing;

(b) diversification;

(c) investment income;

(d) easy gearing; and/or

(e) tax deductibility.

Broad appeal

141 The products appealed to people with a broad range of investment experience. For example, about half of the sample had never invested in shares directly,

although they had some investments in property and/or managed funds. Others had experience in and knowledge of direct share investing, although they had not invested in derivatives directly.

142 The products appealed to some young people and young families as entry-level investments. They also appealed to older people, including pre-retirees and retirees, for diversification.

Appeal to both risk-averse and growth-oriented investors

143 The research found that structured products appealed to two different types of investors, for two different reasons. Growth-oriented investors were attracted by the promise of high-growth or *'turbo-charged'* investment strategies, which had the potential to achieve high returns, with a built-in protection or guarantee to minimise potential losses. These investors were typically aware that there were risks in seeking such high returns. A capital protected or capital guaranteed investment gave them greater peace of mind, and the confidence to enter this market.

144 In contrast, some risk-averse investors chose to invest in the same products to avoid any loss at all. They perceived these investments as a safer alternative to investing directly in the share market. They saw the capital protection or guarantee as removing risk. It may be that some investors viewed these investments as a way to have a 'free bet' on an otherwise speculative or risky investment, and somehow defy the general risk–return principle (where relatively higher investment returns can generally only be achieved by taking higher risks).

Products perceived to fill a market gap

145 For retail investors in the research sample, the main perceived advantage of these products was that they seemed to offer a solution and fill a gap in the market, by offering both capital protection and the potential for an attractive investment return.

146 Risk-averse investors, in particular, saw these products as a way to gain a stable investment from a trusted source, such as a major Australian bank. Some rejected term deposits in favour of capital protected or capital guaranteed investments because they were dissatisfied with term deposit rates. For them, money invested in term deposits is *'not working hard enough'*.

147 Risk-averse investors also chose to invest in these structured products to avoid investing directly in shares, which they regarded as too volatile and requiring too much work and knowledge to manage.

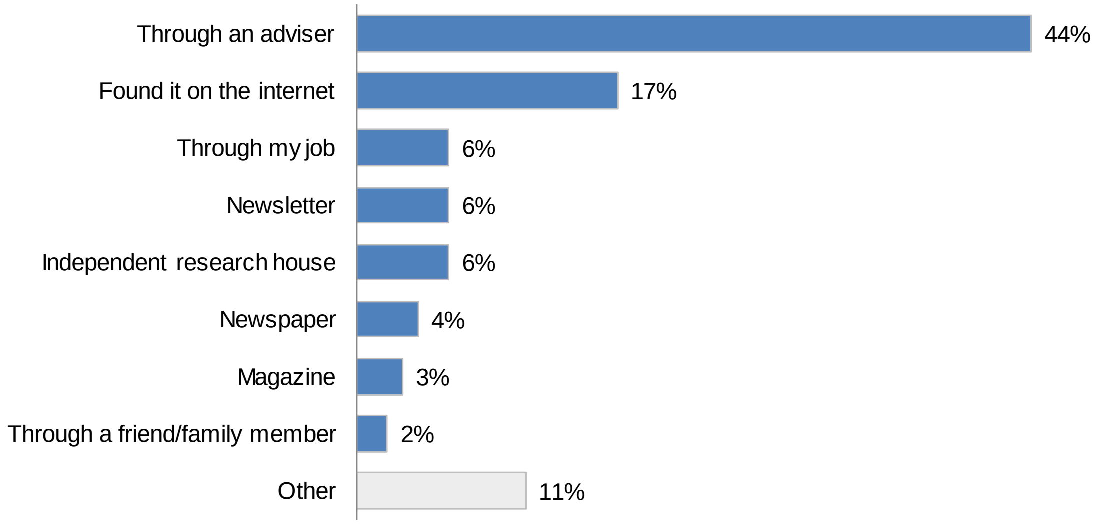
148 Some investors would have preferred to invest in property rather than listed investments, but did not have enough money. Others already had property investments and wanted to diversify.

Investment Trends findings

149 Research by Investment Trends in 2011 found that recent investors in capital protected products were most likely to cite protection against a market downturn (53%), peace of mind and security (16%), tax drivers (15%) and investing in volatile markets with less risk (15%) as the reasons they invested in capital protected products.

150 Advice was also a key driver for some people—56% said their adviser played a role in their most recent capital protected product investment decision, while 44% had learned about their most recent capital protected product investment through an adviser.

Figure 6: How investors first learned about their most recent capital protected investment



Source: Investment Trends, December 2011

151 In a 2010 survey by Investment Trends, investors typically sought a balance between yield and capital gains over the longer term: 32% of investors stated that capital gains were more important than yield, while 25% said that yield was more important.

152 Current investors were more likely to hold capital protected products in combination with other alternative investments that had longer investment terms, higher yield and tax advantages. The alternative investments included private equity funds, unlisted property trusts, infrastructure funds, listed investment companies and hybrid securities. These combinations had high usage among investors who had received financial advice.

153 The key barriers against investing (or investing more) in these products included unfamiliarity with the products, that the products were too expensive or complex, and counterparty risk (including a lack of trust in the product provider or perceived risk of the provider going bankrupt).

Retail investor experiences

154 This section summarises the findings of REP 341, and the experiences of a sample of retail investors who were interviewed. This research identified a range of positive and negative experiences of retail investors in these products, and provided useful insights into investors’ understanding of the products, motivations for investing, and the advice and information they received.

155 A variety of issues were identified. This section describes the key findings in relation to investors’ understanding of the capital protection or guarantee.

Reliance on the brand name

156 Many investors relied on product issuer brand names as an assurance of the product quality. Some did not feel the need to read disclosure documents and gain an understanding of the product, putting their trust in the brand instead. In some cases, they equated the product with other ‘simple’ retail banking products.

157 Confidence in the issuer’s brand also led some participants to assume that the issuer would be supportive and flexible if the product or client encountered difficulties. However, at least one investor discovered that they could not withdraw when they wanted to, because of the product’s strict conditions and illiquid nature.

‘Capital protection’ equated with ‘capital guarantee’

158 Most investors interviewed considered ‘capital protection’ to be the practical equivalent of a ‘capital guarantee’. In both cases, investors stated that their entire capital would be returned and that the investment had the ‘*backing*’ of the bank. They took ‘protection’ to mean ‘unconditional protection’.

159 Some participants who had borrowed to invest misunderstood what the protection applied to. They did not understand that the money they paid for the loan (e.g. interest payments and fees) was not protected.

Low awareness of the conditions on protection

160 With the exception of some experienced investors, few participants were aware of the conditions on the capital protection or guarantee that were common with these products. While they knew that there would be a financial penalty if they withdrew early, very few were aware of the possible extent of that penalty.

161 Similarly, most investors were not aware of the potential for some investments to become frozen or cash-locked. Those who knew that this situation could occur only knew because it had happened to them.

162 Some investors did not realise that returns could be capped or limited.

Low understanding of the costs

163 The research found that, when deciding to invest, participants assumed that fees, interest charges and the effects of inflation would have an insignificant impact on their final investment return. Some investors whose products matured during or after the global financial crisis discovered that their return was much lower than expected, and then was lowered further by fees and interest rates. Some found their investments in 'cash lock', earning no return, even though they were still paying interest and fees: see Case study 1 in Section C.

164 Few participants had considered product fees before investing. Where they did, investors expected them to be easily covered by the investment return. Some whose investments had matured believed that the fees had eroded too much of their return. Investors did not anticipate the impact that fees might have on their capital if the products went into cash-lock, because they did not know what cash-lock was, nor anticipate the possibility of it happening.

165 These investors did not worry about the effects of inflation on their investment, because they presumed these effects would be small. They did not consider the opportunity cost of having their money in a long-term investment.

166 Participants who borrowed to invest did not typically compare the interest rate they were paying with market rates. Depending on prevailing rates and whether the investment was cash-locked, some investors found that they would pay more in interest than they would receive in gain.

Mixed understanding of the risks

167 The research found that participants generally understood that they could lose money because of extreme events, such as a bank *'going belly up'*—a risk they considered unlikely.

168 Typically, participants took short cuts when assessing risks. For example, they looked at relatively low or modest expected returns and deduced that the risks would therefore be low or modest.

169 Participants did not generally anticipate the consequences of committing to a long-term investment, should their personal or financial circumstances change. These investors did not anticipate the impact of lifestyle changes—such as getting married, having children or being made redundant—on their financial situation and payment obligations. If they did consider such events, they tended to be optimistic about the bank or product issuer's willingness to be understanding and flexible.

Poor understanding of the nature of the product

170 The research found that some participants' lack of understanding of the conditions, costs and risks occurred because of the way that they

conceptualised the product. They treated the investment as if it were a *de facto* term deposit (with higher interest) or another retail banking product. Just as they would for these retail products, these investors placed their faith and trust in the bank, without inquiring deeply about how the bank would fund the product. Many of these participants had not considered the cost of the protection.

171 While experienced investors understood that their investment was relatively 'exotic', and may have used instruments such as hedge funds, options and other derivatives, some inexperienced investors believed that they were directly investing in shares, or in managed funds that invested in shares, when this was not the case. Most investors did not know that the products used derivatives and were unable to explain what derivatives were. Some investors even stated that they would never invest in a product that used derivatives, which they perceived as risky instruments.

Unrealistic expectations

172 Some participants had unrealistic expectations about the potential investment performance. For example, one investor in an 'internally geared' structured product (see paragraph 108) said:

> I am hoping I will get more than my capital back, that it goes up ridiculously high … the graph showed where it could potentially go … could double or triple or quadruple. That is 400% more than what I started with and it is all possible.

Limited consultation and/or inappropriate financial advice

173 Many participants in the research sample had invested directly without advice or a detailed product comparison. They learned of the products through advertising, property and general investment seminars, and from bank websites and marketing.

174 Others—particularly, self-described 'cautious' investors—had received financial advice, with advisers proactively recommending these investments because of the protection or guarantee. Some of these investors believed that their adviser did not advise them appropriately. Some suggested that the advisers themselves had not understood the products well. We are conducting a review of financial advice on structured products based on this and other findings from the research.

Low reliance on documentation

175 Many participants invested directly after reading fact sheets and summarised information on issuers' websites. While some paid close attention to disclosure materials, many tended not to read in full or understand PDSs, which are often

lengthy and complex. As a result, they did not read the full detail explaining how these products worked, and their conditions and risks.

176 When the researcher provided participants with extracts from the relevant PDSs, some were surprised to read of risks they had not been aware of. 'It seems more risky, now that I have read this,' said one investor.

177 The research also suggested that, when these products encountered problems caused by falling markets, investors did not always receive information (or, at least, information that they could understand) to notify them of this change.

178 These findings suggest that product issuers and promoters should take particular care to ensure their marketing materials, websites and other product summary documents are balanced, clear and identify product risks. Issuers cannot rely on investors reading PDSs in full, and often these PDSs are lengthy and difficult for consumers to understand. In addition, communications to investors about product performance, particularly where the product is not performing well, should be clear and expressed in a way that consumers will understand.

Mixed satisfaction with investments

179 Research participants who had invested after the global financial crisis expressed satisfaction with their investment. They felt shielded from the subsequent volatility of the share market, and their investments had grown in value. Some participants who had invested in products that matured before the crisis also expressed satisfaction, having experienced high returns and a return of their capital.

180 However, others were less satisfied. Some current and past investors had their capital returned but their investment was less successful than they expected. Some investors found that, as markets fell, the costs of investing reduced their investment gain by more than they expected, which meant that locking the money away for a long term had not paid off.

181 Some investors were dissatisfied because their investment had been 'suspended' (in 'cash-lock'), to their surprise. Their investment had stopped increasing in value and, for some investors, losses were mounting because of loan interest and fees. People who had borrowed to invest continued to pay loan interest, despite limited or no likelihood of a positive return at maturity.

182 Some investors regretted committing to a long-term investment or a loan that they could not easily get out of when their lifestyle or circumstances changed.

Conclusions from consumer research

183 The qualitative research by Susan Bell Research identified a number of problems for retail investors in structured products. Retail investors often:

(a) paid little, or insufficient, attention to disclosure documents;

(b) were heavily influenced by product labels and terms such as ‘protected’ and ‘guaranteed’; and

(c) had a poor understanding of how these products function, and the outcomes they could expect.

184 In some cases, consumers in the sample received poor financial advice and poor post-sales communications from product issuers, particularly when products became frozen or cash-locked.

E Marketing review

Key points

The purpose of our marketing review was to identify whether marketing materials contained problematic claims, and to take appropriate actions to remove potentially misleading terminology and statements.

Structured products within the scope of this project tend not to be advertised in mass media. We analysed promotional and explanatory material on issuers' websites, which may influence consumers' decisions to invest.

Marketing practices vary widely. In some cases, similar products are described and framed in diametrically opposed ways. For example, similarly leveraged products may be described as 'capital protected' by one issuer, or as 'speculative' and 'not suitable for investors seeking capital protection' by another.

We consider terms such as 'conditional capital protection' are at risk of creating a false impression of the characteristics of structured products among retail investors, particularly where investors may lose some or all of their capital.

The influence of product labelling and advertising

185 The advertising and promotion of financial products generally can have a significant impact on consumers' decisions to invest. Retail investors often do not read or understand the full PDS, tending to rely on shorter and more engaging marketing materials instead.

186 The qualitative consumer research discussed in Section D found that consumers tend to be attracted by advertised features or labels such as 'protection' and 'guarantee' without necessarily understanding the conditions, particularly when products described with these terms are combined with a trusted brand such as that of a bank.

187 Our guidance in Regulatory Guide 234 *Advertising financial products and advice services: Good practice guidance* (RG 234) on advertising financial products and advice services was released in February 2012—approximately six months before we reviewed issuers' websites. RG 234 notes that:

> Care should be taken when using certain terms and phrases in an advertisement, particularly where the way those terms and phrases are used is not consistent with the ordinary meaning commonly recognised by consumers (e.g. 'free', 'secure' and 'guaranteed'): RG 234.91.
>
> Some terms and phrases can have such a strong connotation for consumers that they should only be used in advertising with great care. While literally correct, it may be inappropriate to use them in consumer advertising: RG 234.92.

188 Our discussions with structured product issuers also reinforced the importance of product labelling for investor decision making and for financial advisers' ability to sell these products. Some advisers told us that retail investors are more likely to be attracted to a product described as having 'conditional capital protection', compared to a functionally and economically equivalent product that does not have that description.[16]

Scope and findings of our review

189 Most of the products we reviewed for this report tend not to be advertised in mass media. As described in Section B, they are niche products in terms of the overall financial services market, and are usually distributed with financial advice.

190 However, most product issuers provide product marketing and descriptive information on their websites. Between August and December 2012, we reviewed the websites and related online materials of 10 issuers of structured products labelled or described as 'capital guaranteed' or 'capital protected'.

191 We assessed this advertising against our good practice guidelines in RG 234, as well as assessing the content for statements that we may consider to be potentially misleading or deceptive under the Corporations Act and the *Australian Securities and Investments Commission Act 2001* (ASIC Act).

192 We identified some clear and accurate advertising of structured products, where the nature of these products and their risks were appropriately explained to retail investors. However, we also identified a number of concerns in other promotions. This section describes these findings, and Table 4 compares and contrasts different approaches to the advertising of structured products in the market.

Product labelling and descriptions

193 As discussed throughout this report, the labelling or description of complex structured products, using words such as 'capital protected', 'capital guaranteed' or 'conditional capital protected', is common across the industry. These terms can have a significant impact on consumers' perception of the products and the risks, and consequently their willingness to invest.

194 The following sections note differences in how two types of products (internally geared and capital-at-risk)—where investors may experience a net financial loss—are described by issuers.

[16] These trends are also seen in the exchange-traded structured products market, where—anecdotally—labels such as 'synthetic' (for exchange-traded funds and structured products) appear to have a negative influence on issuers' willingness to bring a product to market, and on retail investors' willingness to invest in them.

Internally geared products

195 Our observations about the marketing and labelling of internally geared structured products are as follows:

(a) The risks of investing in these products were often framed in positive terms—for example, as providing capital protection.

(b) These products were mostly described as having a limited recourse loan. However, there was no explanation of whether the loan was ‘notional’ (with leverage created through call options or other derivatives), rather than a ‘real’ loan as consumers would understand it. We are concerned that this disclosure may risk misleading investors about the potential tax deductibility of these products in cases where in economic substance there is no loan, or potentially no loan interest payments that may be deductible.

(c) In some cases, insufficient disclosure was made of the fact that the investor’s outlay would not be protected and was at risk of loss.

(d) Conversely, in some cases, apparently similar products were described as risky investments that did not involve a loan. Such issuers described the consumer’s outlay as payment for the costs of gaining an investment exposure, rather than describing the outlay as interest for a limited recourse loan. The term ‘capital protection’ was not used.

Capital-at-risk products

196 Our observations about the marketing and labelling of capital-at-risk products are as follows:

(a) As above, the risks of these products were often framed in positive terms as providing contingent or conditional capital protection. In all of the examples that we reviewed, we did not consider the use of these terms to be helpful for consumers and, in some cases, we considered the terminology may be misleading.

(b) In some cases, these products were compared favourably with term deposits, or as generally suitable for term deposit investors. This is inappropriate, given the risk of capital loss and that these products are not covered by the Federal Government’s financial claims scheme.

(c) Some providers described these products in terms of their risks, rather than ‘conditional protection’ features. They clearly stated that the investments did not offer capital or principal protection, and were only suitable for investors willing to accept the risk of capital loss.

Limits of capital protection and language used

197 ‘Capital protection’ generally has conditions and exclusions that can have a significant bearing on outcomes for investors, particularly if the protection is revoked or cancelled. For example, a key risk of many structured products is

that an early termination event (see paragraph 84) may occur, invalidating any capital protection.

198 In many cases, websites contained insufficient explanation about the events that could cancel any capital protection, relying instead on retail investors finding this information in the PDS. However, our consumer research shows that many retail investors are unlikely to read the PDS to check the meaning of these terms.

199 Similarly, some product issuers used jargon and terms in their advertising that most consumers are unlikely to understand without an adequate explanation, again relying on consumers to identify these key risks from the PDS.

Suitability

200 Some websites framed structured products as suitable for term deposit investors. We consider this inappropriate because of the different risk profile of these products, which are not bank deposits and are not covered by the Federal Government's financial claims scheme. When these products are compared with term deposits, there is a significant risk that consumers will be misled into thinking that structured products have a similar risk profile to bank deposits, but with a higher return.

201 Better advertising explained clearly that the structured product was not a bank deposit and did not have the same level of protection. It did not suggest that the product was suitable for bank deposit investors.

Worked examples and break-even disclosure

202 Some issuers' marketing documentation provided scenarios and worked examples that showed possible positive, negative and neutral scenarios. However, there were also cases where only positive potential scenarios were portrayed.

203 More descriptive promotional and disclosure material provided details of the market or reference asset performance that was required for retail investors to break even or make a profit, after fees and expenses. However, in other cases, these key disclosures were not provided in PDSs, nor on websites or in marketing material.

204 In one case, worked examples comparing the potential benefits of a protected equity loan with a direct shareholding failed to account for the impact of the fees associated with the protection feature. This led to a potentially misleading comparison which overstated the benefits of the protected equity loan. The product issuer amended its promotional materials after we raised this concern.

A comparison of advertising findings

205 Following the completion of these website reviews, we will consider regulatory action where merited. We are writing to a number of product issuers and promoters where we have concerns about the advertising or promotion of their structured products.

206 Table 4 compares some of the different treatment that similar products, and their features and risks, are given by product issuers. We are concerned that this inconsistency creates problems for both consumers and industry. Retail investors may be confused by the contradictory descriptions and promotion of products within the same class or category, which may limit their ability to compare products and impede confident and informed decision making. For industry, varying approaches and standards create an uneven playing field.

207 Table 4 is not regulatory guidance, but provides examples of practices we observed that we consider likely to provide investors with an accurate representation of these products, and examples of practices at risk of creating unrealistic impressions and expectations among investors.

Table 4: Alternative approaches to advertising structured products

Advertising/product feature	Examples of good practice	Examples at risk of misleading consumers
Comparison with other retail products and investments	No inappropriate comparisons are made between structured products and retail banking products or 'vanilla' debt instruments such as bonds.	Structured products are framed as comparable to term deposits, but with better returns.
Capital protection description	A clear explanation is provided about limits and conditions, and the events that may lead to capital loss.	Jargon and terms are used but not explained—for example, 'call events' and 'early maturity' events.
'Capital-at-risk' products	Products are described using terms such as 'not capital/principal protected', 'high risk', and 'you may lose some or all of your money', as appropriate.	Products where the investor's capital is at risk are described as providing 'contingent' or 'conditional' capital protection, or with similar terms.
Break-even level	A clear description is provided about the investment performance required for investors to break even or make a profit.	No description or examples are provided of the investment performance needed to break even.
Worked examples and scenarios	Positive, neutral and negative scenarios are included.	Only positive outcomes are portrayed.
Investor suitability	Clear disclosure is provided where products are complex or risky, and may not be suitable for particular investors.	Complex or risky structured products are described as suitable for retail banking depositors.

Advertising/product feature	Examples of good practice	Examples at risk of misleading consumers
Derivatives/synthetic products	An explanation is provided, where derivatives are used, rather than a direct investment in the reference assets (such as shares).	The advertising is silent on the use of derivatives. (Investors may assume their investment holds the underlying reference assets.)
Internally geared synthetic products	If applicable, products are described as ‘risky’ or ‘speculative’, where investors may lose some or all of their capital outlay. Where leverage is synthetic, rather than a conventional loan, the difference between these types of leverage is described.	For certain synthetic products, the issuer states that a loan exists, without disclosing where leverage is created with derivatives. Risks are framed in positive terms as ‘capital protection’.
Tax deductibility	No potentially misleading claims are made about the potential tax deductibility of loan interest payments.	The advertising claims or suggests that payments are tax deductible for products without an ATO product ruling or substantiation in the PDS. The advertising does not prominently state any potential risks of claiming deductions for such products.
Identity of the product issuer	There is clear and prominent branding and disclosure of the identity of the issuer, and the role and responsibilities of other parties.	The identity of the issuer is obscured by prominent branding of a bank or other entity.

Source: ASIC

F Investor complaints

Key points

We analysed the complaints ASIC received in relation to 'capital protected' or 'capital guaranteed' structured products between 1 January 2010 and 30 June 2011.

In many cases, investors did not understand the potential to lose money in products that were sold to them as 'capital protected'. Other complainants alleged inappropriate advice, and the failure of advisers to disclose or explain essential product risks and features, including the nature of the capital protection.

The Financial Ombudsman Scheme (FOS) does not have a specific category for structured product complaints, but notes that relevant complaints tend to be concentrated on products that promise a capital protection or guarantee at maturity and that are funded by credit.

Scope of our review

208 The purpose of our review was to better understand the problems or misunderstandings that some retail investors have experienced when investing in structured products that are described as 'capital protected' or 'capital guaranteed'.

209 We collected and reviewed the complaints about capital protected or capital guaranteed products that were referred to ASIC's Misconduct and Breach Reporting team between 1 January 2010 and 30 June 2011.

210 Our focus in this report is not the final outcome of complaints made to ASIC. Rather, we present an analysis of the type of complaints received. Complaints to ASIC did not necessarily result in findings against the product issuer or adviser. Some complaints were resolved by agreement or dismissed because of inadequate evidence. Others may remain under current investigation.

211 Given the medium- to long-term nature of many structured products and the difficulty retail investors have in understanding them, it is possible that some complaints will only arise at product maturity (i.e. in the future for current products), particularly if the products do not perform as expected.

Complaints to ASIC

212 The complaints received by ASIC can be categorised under four main headings, with most complaints covering more than one of the following topics:

(a) understanding of the product(s), including the protection or guarantee;

(b) financial advice;

(c) disclosure; and

(d) AFS licensee obligations.

Product understanding

Investor assumptions about safety and performance

213 A number of complainants were surprised when their investment performed poorly, and to learn that they would not receive the return they had expected.

214 Some complainants alleged that their mistaken assumptions about the product performance they could expect were the result of misleading advertising or advice about the potential for significant investment returns.

215 Some investors did not fully understand how interest repayments (if the investment was geared) or poor performance of the underlying asset would negatively affect the returns on their investment. In particular, some complainants made incorrect assessments of the risk and potential for growth because they did not understand the complex payoff structures in different market conditions, or the structure of the underlying asset (especially if the products had a derivative component).

Lack of understanding about the guarantee or protection

216 In most complaints, there appeared to be a general lack of understanding about the nature of the capital guarantee or capital protection provided, and when it applied.

217 For example, in many cases, the capital guarantee or capital protection only applied if the investment was held until maturity (typically five years or more). A number of complainants were frustrated when they found out that they were unable to withdraw their funds early or access their investment without incurring break fees. Instead, these complainants were left with illiquid, complex and expensive investments.

218 Furthermore, some complainants were frustrated when they realised that capital protection would not apply to their investment, having understood that it would apply at all times. Capital protection offered was narrow in scope and highly conditional—no longer applying, for example, when underlying assets performed poorly and fell by a predetermined percentage.

Financial advice

219 A number of complainants raised allegations of inappropriate advice to invest in capital protected structured products. Complaints alleged that advisers had given inadequate consideration of the suitability of these products for their

clients, in light of the clients' inexperience in investing in complex structured products, their circumstances and their investment objectives.

220 For example, we received complaints that the advice to invest in products with a 100% investment loan was inappropriate for particular clients, since the level of borrowing was too high for them to sustain.

221 We also received complaints raising concerns that advisers did not take into account the affordability of products, or tailor advice about these products to the risk tolerance and expected return profiles of investors.

222 Some complainants alleged that advisers had encouraged them to invest by advising that their capital was fully protected and there were no risks involved in investing in the products. In some of these cases, advisers were alleged to have failed to consider the potential risk of relevant market or economic changes, such as trigger events that can lead to products becoming cash-locked, or events that cause the capital protection to no longer apply.

223 We are currently reviewing financial advice on structured products to assess how well advisers disclose and explain these key features and risks to clients.

Disclosure

224 Several complainants stated that the costs associated with investing in capital protected products had not been properly disclosed to them.

225 Some complained that product fee structures were not transparent, with no proper disclosure about how costs or fees might affect the return of their capital.

226 In relation to advertising and product disclosure, some complainants alleged they were misinformed by product issuers or financial advisers about the key risks of investing in capital protected products. Several believed the risks had not been properly disclosed, or that products were sometimes inaccurately promoted or represented as safe, secure and low-risk investments, when there were inherent risks (e.g. the impact of market volatility on potential returns, and counterparty risk).

227 Other complainants alleged that specific risks, such as the impact of interest repayments on potential growth, and the taxation consequences of investing in geared products, were not explained.

228 Concerns were raised about inadequate disclosure of how products would perform in different market conditions. This raises concerns that the performance of underlying assets that is required to generate a positive return is not being explained to some retail investors.

AFS licensing obligations

229 Complaints to ASIC about the failure of product issuers and advisers to meet their AFS license obligations often related to how the licensee dealt with their complaint before they contacted ASIC (through their internal complaints handling system and/or external dispute resolution scheme).

230 Other complaints in this category included alleged licensee misconduct, including unconscionable conduct, and complaints about the competence of licensees or their representatives to provide the financial services.

Complaints to the Financial Ombudsman Scheme

231 The Financial Ombudsman Scheme’s (FOS) disputes database does not specifically categorise structured product disputes. However, FOS identifies the following trends in capital protected or capital guaranteed structured product disputes:

(a) There are far more disputes against advisers than product providers in relation to structured products. This may not be surprising, given that retail investors in structured products tend to have advisers (see paragraph 136).

(b) The number of investment disputes against product providers, however, is rising, with some complaints being lodged by investors who are represented by the adviser that recommended the product. This trend reflects managed investment scheme disputes, generally, rather than being limited to structured products.

(c) Structured product disputes typically involve products with a ‘capital guarantee’ (at maturity) and that are funded by credit. They almost invariably involve allegations that the nature (and more particularly the limits) of the capital guarantee were inadequately explained in disclosure documents (if the complaint is lodged against the product provider) or by the adviser (if the complaint is against the adviser).

(d) FOS has also received some financial difficulty disputes lodged in relation to structured products, when a shortfall after the investment is sold means the consumer is unable to repay outstanding debts relating to the structured product.

G Policy issues and future action

232 This report identifies significant issues in the naming and description of certain complex and risky structured products. These descriptions and labels may create a perception of safety that is inconsistent with the product risks.

233 There is clear evidence that consumers often have a poor understanding of the nature and risks of the structured products they invest in, and tend not to read and understand disclosure documents.

234 The opaque and complex nature of structured products can place retail investors at a significant disadvantage.

235 The relationship between product issuers and investors is starkly asymmetric, and in some cases product disclosure, marketing and financial advice have been unable to bridge this gap in consumer knowledge and understanding.

236 Our preliminary review of some of the financial advice on these products has found examples of appropriate advice. However, the review also indicates a number of concerns, including the apparent use of 'boilerplate' advice models that are not tailored to individual investors' needs, advice resulting in a high concentration of retail investors' assets invested into single structured products, and the omission of key risk explanations in the advice. The potential influence of commissions in the recommendation of certain leveraged products is also concerning.

237 We will soon complete our review of the sample of advice files and will consider appropriate action based on our findings. This is likely to include:

(a) further surveillance or enforcement action when necessary;

(b) feedback and discussion with individual licensees about the findings of our advice file reviews; and

(c) a public report outlining the findings of the advice review.

238 We expect industry to proactively address the problems identified for retail investors in this report. We will continue to monitor industry practice in the description and labelling of structured products. Where significant issues in the market persist, we will consider appropriate regulatory options, particularly in relation to the description of medium-risk and high-risk financial products using terms such as 'capital protected'.

239 ASIC continues to play a strong role in the international focus on structured products and other complex investments, particularly through the International Organization of Securities Commissions (IOSCO) and its Taskforce on Unregulated Markets and Products.

Key terms

Term	Meaning in this document
ADI	Authorised deposit-taking institution
advice	Personal advice given to retail investors
advice licensee	An AFS licensee that provides personal advice to retail clients
adviser	A natural person providing personal advice to retail clients on behalf of an AFS licensee who is either: • an authorised representative of a licensee; or • an employee representative of a licensee
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee or licensee	A person who holds an AFS licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
ASX	ASX Limited or the exchange market operated by ASX Limited
authorised representative	A person authorised by an AFS licensee, in accordance with s916A or 916B of the Corporations Act, to provide a financial service or services on behalf of the licensee Note: This is a definition contained in s761A.
ATO	Australian Taxation Office
capital	The amount of an investor's initial investment
capital protected or capital guaranteed	These terms are used in a variety of inconsistent ways across the financial services industry. Products that are described as offering capital protection may range from deposits with prudentially regulated entities to leveraged investments with limited recourse loans, and structured notes where the investor's capital return bears the risk of the reference assets
capital-at-risk products	See paragraph 119 of this report for a definition

Term	Meaning in this document
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
CPPI products	Constant proportion portfolio insurance products, as described in paragraphs 96–99 of this report
financial advice	Personal advice given to retail investors
financial product	Generally, a facility through which, or through the acquisition of which, a person does one or more of the following: • makes a financial investment (see s763B); • manages financial risk (see s763C); • makes non-cash payments (see s763D) Note: See Div 3 of Pt 7.1 of the Corporations Act for the exact definition.
limited recourse 'protected equity' loan	See paragraph 86 of this report for a definition
OTC	Over the counter
PDS	Product Disclosure Statement
personal advice	Financial product advice that is given or directed to a person in circumstances where the provider of the advice has considered one or more of the person's objectives, financial situation and needs, or a reasonable person might expect the provider to have done so Note: See s766B(3) of the Corporations Act for the exact definition.
Product Disclosure Statement	A document that must be given to a retail client in relation to the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act Note: See s761A for the exact definition.
RBA	Reserve Bank of Australia
reverse convertibles	See paragraph 119 of this report for a definition
s913B (for example)	A section of the Corporations Act (in this example numbered 913B)
SMSF	Self-managed superannuation fund
SPV	Special purpose vehicle, as described in Table 2 in Section B of this report
structured products	Unlisted and unquoted retail structured products that are traded over the counter: see paragraph 11 of this report for a definition of 'structured products'

Related information

Headnotes

capital guaranteed, capital protected, derivatives, leverage, limited recourse borrowing, options, protected loans, structured products

Regulatory guides

RG 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)*

RG 234 *Advertising financial products and advice services (including credit): Good practice guidance*

Legislation

ASIC Act

Banking Act 1959

Corporations Act, s761A, 766B(3), 911A(2)(b), 913B, 916A–B

Income Tax Assessment Act 1997

Cases

Utopia Financial Services Pty Ltd v Financial Ombudsman Service Ltd [2012] WASC 279 at [47]

Consultation papers and reports

CP 167 *Advertising financial products and services: Good practice guidance*

REP 201 *Review of disclosure for capital protected products and retail structured or derivative products*

REP 341 *Retail investor research into structured 'capital protected' and 'capital guaranteed' investments*

Media and information releases

11-144MR *ASIC imposes licence conditions on JB Global*, 18 July 2011

11-277MR *Westpac reviews use of 'stress-free' in response to ASIC's concerns*, 1 December 2011

12-256MR *City Index Australia pays infringement notice penalties*, 22 October 2012