Deutscher Derivate Verband

Notes to the Fairness Code

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Preamble

1. New name: Fairness Code

The Fairness Code is a voluntary undertaking by the members of Deutscher Derivate Verband (DDV), the German Derivatives Association, who represent approximately 95 percent of the structured products market in Germany. The Code sets out guidelines for the structuring, issuing, marketing, selling and trading of structured products.

While the term Derivatives Code was principally intended to make it clear to which financial products the voluntary undertaking pertains, the term Fairness Code now places an even greater emphasis on the spirit of the Code, i. e. fairness in dealing with customers. The concept of transparency is particularly important in this context. Therefore cost transparency, in addition to product transparency, now also plays a crucial role in the Fairness Code.

2. The need for updating

The old Code already needed to be continuously updated and adapted to new national and international framework conditions. The members of DDV have fulfilled this self-imposed task – including as regards the anticipated regulatory measures at European level. By means of a strict voluntary commitment the DDV intends to send a strong signal and contribute to an appropriate and goal-oriented regulation which offers private investors real added value.

3. Difference between the old Derivatives Code and the new Fairness Code

The Fairness Code contains significantly stricter guidelines for structured products than the previous Derivatives Code. This applies in particular to the voluntary commitment as regards cost and product transparency for investment products.

The members therefore agreed that in future the issuer estimated value (IEV) should be shown in the product information sheets of investment products as a percentage or in euro or in the respective currency of the investment product.

The issuer estimated value must be calculated on the date when the product conditions are determined and reflect the market price of the product among professional market participants.

The difference between the issue price of the product plus a front-end load fee, where applicable, and the issuer estimated value should include the expected issuer margin and, where applicable, a sales commission. The expected issuer margin covers inter alia the costs of structuring, market making (continuous pricing on exchanges and in the over-the-counter markets) and settlement of the respective structured product and it also includes the expected profit for the issuer.

By showing the issuer estimated value, the DDV members provide maximum cost transparency for the investors. The German structured products industry is a pioneer in this for all types of securities and financial products in Germany and other European countries. No other industry so far has subjected itself to such strict voluntary commitment as regards cost transparency.

The members of DDV have also agreed that in future, where investment products with full capital protection are concerned which have a minimum and a maximum interest yield, the members must indicate the respective probabilities of occurrence as at the date when the product conditions are determined in the relevant product information sheet. With this they want to help investors make a better estimate of potential returns for the respective investment products. No other provider of capital-protected financial products has so far been willing to provide this information. This would, however, be an important point of reference for safety-oriented private investors, enabling them to compare the various financial products fairly with one another.

In the new Fairness Code the members expressly undertake to design their structured products fairly and illustrate this by a number of concrete examples. In this way they ensure that there is no imbalance between potential returns and related risk where the respective pay-off profile of the structured product and the market expectation associated with it are concerned. They will also ensure that on the date when the product conditions are determined the best possible return on the respective structured product is greater than the return on a government bond with a comparable term.

The members must not promote any positive product features which only occur under unlikely circumstances, and they must use clear, unambiguous concepts when designating the products. This is to prevent potential false incentives for an investor's investment decision.

4. Replacing the term derivative with structured

The term structured products is continuing to gain acceptance at international level. It also highlights the fact that structuring creates additional value for the investor. By contrast, many people associate the term derivative with the credit derivatives market which is geared to institutional investors and has a volume in excess of 600 trillion dollars, i. e. of more than 456,000 billion euro. Structured products, on the other hand, are almost exclusively acquired by private investors, with the market volume in Germany currently amounting to around 92 billion euro.

5. Benefits of the Fairness Code to private investors

The new Code offers the greatest possible cost transparency by comparison with other securities and all other financial products. No other industry so far has subjected itself to such strict voluntary commitment as regards cost transparency.

6. Scope of the Fairness Code

The Fairness Code governs structured products which are offered publicly to private individuals in Germany. It does not apply outside Germany.

1

Issuer

Structured products, just like bonds, are debt instruments. In principle, this means a credit risk for the investor. If the issuer becomes insolvent, this can therefore result in a total loss of the capital invested. On trading days, the DDV publishes the credit spreads, where available, of all the important issuers of structured products in Germany. These can be found on www.derivateverband.de and are intended to help reliable assessment of the creditworthiness of a structured products issuer. The DDV uses credit default swaps (CDS) as a basis for this. These give the cost of hedging a bond from the issuer in question. The higher the hedging costs for a bond, the higher the market estimates the probability of a default in payment. Rising CDS spreads are therefore a negative signal, whereas falling CDS spreads are a positive signal.

2

Underlying

(No substantial changes)

Product

3

1. Relationship between potential returns and risk

Every pay-off profile of a structured product is associated with a specific market expectation which should correspond with the market expectation of the purchaser of this instrument. The members must ensure that there is no imbalance between potential returns and inherent risk as concerns this market expectation. This must be checked for each structured product. There is an obvious imbalance if, as regards market expectation, a low probability of anticipated returns is associated with a disproportionately high risk. In principle, the expected return must be proportionate to the risk profile of a structured product.

2. Probability of a maximum and a minimum interest yield

Where investment products with full capital protection are concerned which have a minimum and a maximum interest yield, the members must indicate the respective probabilities of occurrence as at the date when the product conditions are determined in the relevant product information sheet. They must use the same model as a basis to calculate these probabilities as with the issuer estimated value.

3. Exclusion of certain structured products

In the new Fairness Code the members commit themselves not to issue any structured products which do not satisfy certain minimum conditions or relate to specific underlying instruments.

The members will therefore refrain from issuance if, on the date when the product conditions are determined, the maximum return on the respective structured product is not greater than the return on a government bond with a comparable term. This condition applies in particular to investment

products with full capital protection as they represent an alternative to fixed-income investments.

The members must also not offer any structured products for sale to the public which relate to individual investment funds as underlying instruments if the investment funds cannot be approved for sale in Germany (e. g. single hedge funds as defined in section 283 of the German Capital Investment Code – KAGB), if their current valuation is not published or only at long intervals (e. g. private equity funds) or if their repurchase is subject to substantial restrictions (e. g. closed-end funds).

4. Clear terms for product names

A distinguishing characteristic of the market for structured products in Germany is that, for many types of product, uniform terms which also reflect the essential product features have become the market standard. This applies, for example, to discount certificates which grant a discount on the current market price of the underlying asset, and also to express structured products offering early payback provided the price of the underlying asset does not reach or exceed a specified threshold on an observation date.

5. Fair advertising statements

The members must not promote any positive product features which only occur under very unlikely circumstances. This would be the case, for example, if an instrument were advertised at a 10 percent return in a low interest rate environment yet according to the issuer's forecasts the investor had only a 1 percent chance of obtaining this yield.

6. Sales partners’ compliance with the Code

The legislators have provided clear guidelines for the sale of securities and given sellers the responsibility for this, as also demonstrated by the example of the product information sheets. In this regard the members, in their capacity as issuers, can only influence sales decisions to a certain extent. As issuers, the members must nonetheless support their sales partners in working towards the responsible distribution of these securities.

The members must recommend that their sales partners also disclose the issuer estimated value to the customers in their product information sheets.

4

Price

The price of a structured product comprises the following components:

Structured product price components

	Model price of the product components
–	Finance income
+	Expected hedging costs
	Issuer estimated value (IEV)
+	Expected issuer margin*
+	Distribution and selling costs (commission)
	Structured product price
+	Front-end load fee, where applicable
	Acquisition price for the investor

* The expected issuer margin includes the operational costs of structuring, market making and settlement of the respective structured product as well as the expected profit for the issuer.

In future, DDV members will state the issuer estimated value of the structured products in the relevant product information sheets as a percentage or in euro or in the respective currency of the structured product. The issuer estimated value must be calculated on the date when the product conditions are determined.

The issuer estimated value should essentially be determined by the model price of the product components. The finance income, which the issuer generates by issuing its structured products, is deducted from this figure and the hedging costs, which the issuer necessarily has to deal with, are added. The total should then reflect the market price of the product among professional market participants. A similar approach

is adopted by the internationally recognised financial reporting standard IFRS 13.

In the case of subscription products, the issuer estimated value is reported at commencement of the subscription period.

1. Model price of the product components

The issuer's model price for the components of the structured product can be calculated using the average market expectations for the value-determining parameters of a product (equity prices, interest, dividends, volatility, etc.) based on recognised valuation models.

These valuation models presume a market that is efficient and perfect, with no transaction costs and no hedging costs, and make mathematical probability assumptions. A further assumption is that financing is based on an average market interest rate which is independent of the creditworthiness of the respective issuer. Although observable market data are used as far as possible in the model price of the product components, it is possible that, due to differing methods and models, issuers do not arrive at the same model price for identical pay-off profiles.

In reality there is no such thing as a perfect market. On the contrary, additional costs and revenues are involved in the issuing of structured products, as explained below.

2. Finance income

As the buyer of a structured product, the investor provides the issuer with money. This may result in finance income for the issuer which is included in the issuer estimated value.

3. Expected hedging costs

If the issuer has sold a structured product to a customer, it has automatically given a performance guarantee. As the issuer does not know how the market will develop and is thus also unaware of how the price of the structured product will develop, there is a risk inherent in this performance guarantee which it will typically offset. Contrary to much of public opinion, the issuer's position vis-à-vis the buyer of the structured product is completely neutral, regardless of whether the latter is speculating on rising or falling markets and irrespective of the type of structured products the investor is acquiring. The issuer must therefore hedge against the open risk positions caused by the sale of structured products directly on the capital market and enter into countertrades which will hedge against this risk as accurately as possible. This securing or hedging involves costs, such as trading costs or bid-ask spreads. Without this hedging, no bank would sell a structured product, either to another bank or financial institution or to a private investor.

4. Expected issuer margin

The difference between the issue price of the product plus a front-end load fee, where applicable, and the issuer estimated value includes the expected issuer margin and, where applicable, a sales commission.

The expected issuer margin covers inter alia the operational costs incurred by the issuer for structuring, market making and settlement of the respective structured product and also includes the expected profit for the issuer.

4.1. Operational costs

The expected issuer margin includes firstly the various personnel expenses and material costs incurred by an issuer when it issues certain products as securities, thus making them accessible and tradable for private investors. Typically it is not possible to determine these operational costs with total precision for each individual instrument. Costs are normally based on internal cost arrangements and calculations which are determined for the entire business of an issuer with structured products and then apportioned to the individual structured product.

This includes in particular the costs of preparing the securities prospectus and the final conditions, admitting the securities to listing on exchanges, pricing on exchanges and in the over-the-counter markets, accounting entries, clearing and settlement of the individual transactions in the respective internal systems and with the custodian banks of the respective investors through the securities settlement systems of central securities depositories (CSDs) and international central securities depositories (ICSDs), such as Clearstream. In addition, there are the costs of a robust, flexible and high performance IT infrastructure. Only in this way is it possible for the issuer, for example, to continuously calculate market prices and adapt them to the current market conditions and / or communicate the relevant prices to the exchanges in real time and make them available to private investors free of charge on its own website as well as on several finance portals. A further cost factor is the on-going computation, by an independent institution, of the value at risk (VAR) figure – a key risk indicator – for virtually every instrument.

Furthermore the issuer markets its structured products in a variety of ways. The issuer contacts in particular self-directed

investors directly via print and online media, through newsletters, newspaper advertisements or customer magazines, at seminars and investor fairs and not least through an extensive Internet presence so as to satisfy the investors' considerable demand for information.

4.2. Expected profit

For the issuer margin, in addition to the operational costs, the issuers also add the profit they anticipate to a structured product. The expected profit in the calculation of a structured product is uncertain, however, and distinction must be made between this and the profit actually achieved by the issuer. Therefore, for example, depending on the market situation, the actual hedging costs may be higher or lower during the term than the expected hedging costs. On the other hand, the costs of securities prospectuses or brochures, for example, are fixed amounts that are incurred regardless of the actual volume of placements. If the forecast volume of placements is not achieved or is exceeded, the expected pro rata expenditures relative to the individual instrument increase or decrease. Such factors as these therefore impact on the profit actually realised.

5. Selling costs

The issuer pays the sales partner a commission for the sales service; this also includes the consultant's advisory service for the investor (explaining the structured product, verifying whether the selected product is suitable for the investor, etc.) which is added to the structured product price in the form of a sales commission. With the exception of fixed-price transactions, sales commissions must be shown in the product information sheet and therefore be transparent.

Trading

5

(No substantial changes)

Service

6

Adding Service to the Code headings

Many guidelines and rules which are already adhered to by all DDV members and were already incorporated in the previous Derivatives Code are relatively unknown to the general public. In the new Fairness Code we want to provide greater clarification with our own section headed Service.

7

Compliance

1. Binding force of the Fairness Code

The new Fairness Code with its added requirements regarding product and cost transparency is binding upon the members of DDV, just as the old Derivatives Code was. Any issuer joining the Association must agree to observe the Code.

Each industry code defines minimum requirements which its signatories must satisfy. Of course, this does not rule out the possibility that with the Fairness Code some issuers will take measures further to these guidelines with respect to individual issues. They can also positively distinguish themselves from the competition in this way.

2. Timescale for implementation of the new requirements of the Fairness Code

The Fairness Code comes into effect on 1 November 2013 and applies to the structured products offered publicly for the first time on that date and thereafter. The issuer estimated value and the probabilities for the minimum and maximum interest yield for investment products with full capital protection will be published at the latest as of 1 May 2014 in the product information sheets of the products offered publicly for the first time on or after this date.

3. Monitoring compliance with the Fairness Code

Compliance with the Fairness Code will be monitored by a scientific advisory board headed by the current chair, Prof. Dr Dirk Schiereck, Chair of Corporate Finance at the Technische Universität Darmstadt. Other members of the advisory board include Prof. Dr. Sigrid Müller, Director of the Institute of Finance at the Humboldt Universität zu Berlin and Prof. Dr. Lutz Johanning, Chair of Empirical Capital Market Research at the WHU – Otto Beisheim School of Management.

4. Sanctions for non-fulfilment of the criteria of the new Fairness Code

In the event of serious infringements of the Fairness Code, the Board of Directors may take appropriate measures against the member concerned, which may result in exclusion from Deutscher Derivate Verband. Realistically, however, this situation should not arise. No member can afford to risk its reputation by having to state publicly that it has failed to comply with the requirements of the Code which it has made a binding commitment to observe.

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