Deutscher Derivate Verband

Notes to the Fairness Code

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Preamble

1. Title: Fairness Code

The Fairness Code is a voluntary undertaking by the members of the Deutscher Derivate Verband (DDV), the German Derivatives Association, who represent more than 90 percent of the structured products market in Germany. The code sets out guidelines for the structuring, issuing, marketing, and trading of structured products.

The term Fairness Code places emphasis on fairness in dealing with customers. The concept of transparency is particularly important in this context. As such, in addition to product transparency, cost transparency also plays a crucial role in the Fairness Code.

2. The need for updating

Included in the Fairness Code is the task continuously updating it and adapting it to new national and international framework conditions. The members of the DDV have fulfilled this self-imposed task - including as regards the diverse regulatory measures at the European level. By means of a strict voluntary commitment, the DDV intends to send a strong signal and contribute to appropriate and goal-oriented regulation that offers retail investors real added value.

3. Scope of the Fairness Code

The Fairness Code governs structured products that are offered publicly to retail individuals in Germany. It does not apply outside of Germany.

Issuer

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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 accordingly 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) with maturities of five years and corporate bonds 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.

Underlying

2

The underlying is the reference object upon which every structured product is based, and which determines the price of the security. Structured products are based on existing underlying instruments or underlyings specifically created for an issuance. The underlying assets are to be clearly designated. Common underlyings include equities, indices, currencies, and commodities. Where possible, payouts are to be calculated on the basis of verifiable reference prices in liquid markets.

3 Product

1. Changes arising from MiFID II and the PRIIPs Regulation

The revised European Markets in Financial Instruments Directive (MiFID II), which entered into force in January 2018, contains extensive provisions on product design and distribution, so as to protect the interests of investors. Of particular importance are provisions on identifying a target market, on product approval and product governance processes, as well as on cost transparency. Members are to develop the organisation and technology of their processes and systems in order to ensure compliance with these requirements. They are to make their information on the target markets and costs of their products available to their distribution partners.

As part of the prescribed product approval process, members are to determine a transparent cost structure, distribution strategy, and target market for their products. As issuers, they are to work with their distribution partners to ensure the responsible distribution of these products.

Members are to provide a corresponding Key Information Document (KID), with all required data and facts, for structured products that are subject to the European PRIIPs Regulation and that will, to their knowledge, be made available to retail investors. If a distributor decides to distribute a structured product that differs from the issuer's target market definition, the issuer is not obliged to prepare a Key Information Document for this purpose.

2. Credit-linked notes

Credit-linked notes intended for distribution to retail clients are to be issued only when in compliance with the "Principles for the issuance of credit-linked notes for distribution to retail clients in Germany" paper adopted by the Deutscher Derivate

Verband and the Deutsche Kreditwirtschaft (DK). Members are to use a separate base prospectus for the issuance of credit-linked notes.

3. Relationship between potential returns and risk

Every pay-off profile of a structured product is associated with a specific market expectation that should correspond with the market expectation of the purchaser of this instrument. Members are to ensure that there is no imbalance between potential returns and inherent risk as concerns this market expectation. This is to be reviewed 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.

4. Exclusion of certain structured products

In the Fairness Code, members commit themselves to not issuing any structured products that do not satisfy certain minimum conditions, as well as structured products that relate to specific underlying instruments.

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.

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

5. 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 that 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 certificates, which offer early payback provided the price of the underlying asset reaches or exceeds a specified threshold on a valuation date.

6. Fair advertising

Members are not to promote any positive product features that only occur under very unlikely circumstances. This would be the case, for example, if an instrument were advertised at with 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 return.

7. Responsible distribution

Members, in their capacity as issuers, can only influence distribution decisions to a certain extent. Nonetheless, they are to support their distribution partners in working towards the responsible distribution of the structured products that they issue.

4 Price

The prices of structured products are determined in free competition among the issuers using the criteria of modern financial markets theory and are based on a number of different factors of influence. Members are to inform investors of the product costs of structured products in the respective Key Information Document or product information sheet.

1. Product costs

In accordance with the revised European Markets in Financial Instruments Directive, these product costs include the entry charges, the ongoing charges, and the exit charges. They also contain the operational costs incurred by the issuer for structuring, market making, and settlement of the respective structured product, as well as the expected profit for the issuer.

1.1 Operational costs

The operational costs include firstly the personnel expenses and material costs incurred by an issuer when it issues certain products as securities, thus making them accessible and tradable for retail 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 that are determined for the entire business of an issuer with structured products, and then apportioned to the individual structured product.

These include, 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 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 retail investors free of charge on its own website as well as on a number of finance portals. 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 and 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.

1.2 Expected profit

In addition to the operational costs, product costs include the expected profit for the issuer. The expected profit in the calculation of a structured product is uncertain, however, and distinction has to be made between this and the profit actually realised by the issuer. For example, depending on the market situation, the actual hedging costs may be higher or lower during the term than the expected hedging costs. In contrast, 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 thus impact on the profit actually realised.

1.3 Distribution costs

The issuer pays the distribution partner a commission for the distribution 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. Sales commissions are to be disclosed, making them transparent.

2. Product costs in product information sheets

Product information sheets still have to be prepared for some products in the Derivatives League, particularly for such instruments as certain capital protection products with coupon. For these products, members are to indicate the costs of the product in the product information sheet at the time the product conditions are determined. In doing so, they go above and beyond the existing regulatory requirements for cost transparency.

3. Cost information for distribution partners

Members are to provide the information on product costs to distribution partners.

5 Trading

(No substantial changes)

6 Service

(No substantial changes)

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Compliance

1. Binding force of the Fairness Code

The comprehensive provisions of the Fairness Code, which serve to ensure product transparency and investor protection in particular, are binding for all members of the DDV. Any issuer joining the association is to agree to observe the code.

Every industry code defines minimum requirements that its signatories must satisfy. Of course, this does not rule out the possibility some issuers will take measures in addition to those outlined in the Fairness Code with respect to individual issues. This will also allow them to positively distinguish themselves from their competition.

2. Entry into force of the Fairness Code

The Fairness Code came into effect on 1 November 2013, and was last updated on 13 March 2018.

3. Monitoring compliance with the Fairness Code

Compliance with the Fairness Code will be monitored by an academic advisory board, the Fairness Code Advisory Board, currently chaired by 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-compliance with the Fairness Code

In the event of serious breaches of the Fairness Code, the Board of Directors may take appropriate measures against the member concerned, up to and including potential exclusion from the 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 that it has made a binding commitment to observe.

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