MiFID II: need for action for Swiss investment firms
The Markets in Financial Instruments Directive (MiFID) has been the cornerstone of capital markets regulation in the European Economic Area (EEA) since its entry into force in 2007. With amendments to MiFID, the European Commission addresses key shortcomings such as investor protection, market structures, functional and product scope, and third country access.

Aiming to strengthen the stability of the financial system, enhancing competitiveness among market participants and regulatory oversight and closing the gaps in the existing framework, MiFID II touches on many topics that are also the object of other regulatory initiatives. This includes the Dodd-Frank Act in the United States, as well as the measures to enhance investor protection planned in Switzerland according to the FINMA distribution report.

Investment firms operating onshore in the EEA will need to fully comply with MiFID II. Switzerland, not being a member of the EEA, will still be impacted by the changes more than it was by MiFID, given the higher level of scrutiny applied by regulators. The changes will specifically affect Swiss investment firms that regularly do business across borders into and from the EEA.

Given the practical implementation date some time in 2015, Swiss investment firms are well advised to assess the strategic impact of the new provisions.

This publication is another element in our “Transformation in Private Banking” series. It is designed to reduce complexity by narrowing down MiFID II to a selected set of key areas that are of strategic importance to the Swiss Private Banking industry. We hope you enjoy reading this brochure and encourage you to contact a member of our team for additional information.
1. Executive summary

Background and timeline
The European Commission launched the MiFID II process, with the market consultation due to be completed in Q3 2012 and first probable date of national transposition in Q2 2014, with expected implementation from 2015 onwards. However, the amendments within MiFID II are far-reaching and will have significant consequences for investment firms like banks, broker-dealers, asset managers and other financial intermediaries. Most of the key areas in the consultation paper have made it through to the draft legislation, including some of the more controversial provisions, such as the abolition of inducements, the concept of independent vs. non-independent advice and the access to the EEA market by non-EEA investment firms. These requirements will fundamentally impact the business model of an investment firm and thereby change how clients are served. The expected shift in revenue streams will require an adjusted product offering.

Main areas Swiss investment firms should focus on now
The strategically relevant and operationally complex MiFID II focus topics are expected to be advised services, inducements, third country access as well as execution and OTC derivatives. Reducing complexity of MiFID II is key to a successful implementation. In addition, we have identified areas which can present a challenge but are of less significance and others that need validation as part of an overall assessment. In the graphic below we have made a preliminary prioritization of the MiFID II focus topics along the dimensions strategic and operational complexity.

Figure 1: Prioritization of the key MiFID II focus topics for Swiss investment firms
Relevance to your business

The relevance of MiFID II to your business will heavily depend on your interaction with clients domiciled in the EEA, and financial instruments distributed there. The table (MiFID II regulatory applicability) provides an overview of levels of MiFID II relevance: direct, indirect and none.

Of particular relevance to Swiss investment firms is that the draft proposal contains a new section dedicated to regulating third country access to the European market, which will replace the individual Member States’ regimes. In order to actively service retail and professional clients domiciled in the EEA, Swiss investment firms will have to establish a branch in an EEA Member State (notably in contradiction with the Final Withholding Tax Agreement between Switzerland and Germany). Such branches will newly be able to benefit from the European “passport” system to access the markets of other EEA Member States.

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2. Background and timeline

Background
The Markets in Financial Instruments Directive (MiFID) has been an essential foundation of capital markets regulation in Europe since its implementation in November 2007. With amendments to MiFID, the European Commission is aiming to address shortcomings of the original release as follows:

- While competition has increased, the envisaged benefits of increased competition have not been passed on to investors, retail or wholesale clients. In addition, increased market fragmentation has made the trading environment more complex and more opaque.

- Market, product and technology developments have been seen as outpacing the provisions of the original directive, with structures such as High-Frequency Trading (HFT) and “dark pools” falling outside the scope of (the original) MiFID.

- The financial crisis exposed weaknesses in the regulation and transparency of non-equity financial instruments, both at trading and retail investment advice levels.

- The level of investor protection is being seen as insufficient due to the rapid innovation and growing complexity in financial instruments.

Conduct of business rules
- Market reach: the new MiFID version extends and reinforces conduct of business rules to all actors in the retail distribution chain, especially intermediaries, institutions selling their own securities and non-financial institutions.

- Product and client coverage: MiFID II extends the conduct of business rules to new asset classes such as structured deposits, limits the “execution-only” regime, albeit within the existing client categorization rules, and allows for institutions such as local authorities to elect for “retail classification.”

- Further strengthening of conduct of business rules and emphasis on conflicts of interest: MiFID II enhances suitability requirements, introduces the concept of independent vs. non-independent advice and imposes a ban on inducements. Moreover, it defines further requirements for portfolio management services and fee transparency.

- Complex products: MiFID II puts a more intense focus on the list of complex products that cannot be sold to retail-classified investors without stringent suitability or appropriateness tests, accompanied by a limited number of products such as cash equities, money market instruments and simple UCITS, to be considered as “non-complex,” requiring no advisory input and thus retention of an “execution-only” model.

Trading
- Functional and product scope: the key focus of the reforms is on pre- and post-trade transparency, and extending these requirements to equity-like products (such as Exchange Traded Funds (ETFs) and Global Depository Receipts (GDRs)), fixed income and Over-the-Counter (OTC) derivatives and commodities. A large proportion of OTC derivatives trading will be forced to migrate onto new electronic trading platforms and existing exchanges – where prices are visible to all – and be subject to extensive reporting requirements. These requirements include near real time trade reporting through Approved Publication Arrangements (APAs). Going forward, only ad hoc trading in shares, bonds and non-standardized derivatives will continue to be allowed to take place OTC.

- Market structure: the rules on market structure will be amended, e.g., by introducing a new category of trading venues called Organized Trading Facilities (OTFs) alongside regulated markets, Multilateral Trading Facilities (MTFs) and Systematic Internalizers (SIs).

- Algorithmic trading: while allowed to continue, a more restrictive regime covering high frequency and algorithmic trading will be introduced with business resilience and continuous liquidity provisions as particular themes.
**Third country access**

As with all EU regulations and directives, the relevance of third country access (i.e., granting access to the common passport for non-EEA firms) is likely to be one of the most controversial areas. The MiFID II draft proposes to introduce a harmonized third country equivalence regime for the access of third country investment firms and market operators to the EEA. In case MiFID II follows a similar direction to the Alternative Investment Fund Managers' Directive (AIFMD), third country regulators will need to pass several mutual recognition tests and/or operate cooperation agreements with EEA regulators.

### Implementation and timeline

MiFIRegulation + MiFIDirective = MiFID II: MiFID II will take the form of a directive that will be transposed into national law, backed up by a regulation which is immediately enforceable by law in the EEA. The regulation component (MiFIR), has been introduced to ensure a maximum harmonization framework implemented centrally from Brussels, with a limited scope for national discretions or derogations, divergent interpretations or Member State “gold-plating.”

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**Figure 4: Timeline of publication and implementation**

<table>
<thead>
<tr>
<th>Current timeline of publication and implementation of MiFID II</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Level 1 rules</strong></td>
</tr>
<tr>
<td><strong>2012</strong></td>
</tr>
<tr>
<td>Q1</td>
</tr>
<tr>
<td>Consultation by EP and Council</td>
</tr>
<tr>
<td><strong>Related projects</strong></td>
</tr>
</tbody>
</table>

¹Level 1 rules, ²Level 2 rules
3. Relevance to your business

Although Switzerland is not a member of the EEA, there are specific impacts generated by MiFID II. These will clearly affect Swiss investment firms dealing with financial services in the EEA. The level of relevance of MiFID II can be categorized as direct, indirect and none, as depicted in the illustration below.

Direct MiFID II relevance entails onshore services provided in the EEA and cross-border services rendered from the EEA (3). All onshore EEA entities of investment firms are taken into account in this context (4 & 6).

Cross-border services from Switzerland to the EEA (2) are defined as indirect relevance to MiFID II. This relevance is due to risk of regulatory sanctions by foreign regulators and increased legal risks given by the revised Lugano Treaty.

MiFID II will have no impact on Swiss investment firms providing only Swiss onshore (1) and cross-border services to non-EEA countries (5). On the other hand, Swiss investment firms will have to comply with the Swiss and foreign local regulations, which potentially could be influenced by MiFID II.

**Figure 5: Relevance**

<table>
<thead>
<tr>
<th>PB service model</th>
<th>BC¹</th>
<th>CA²</th>
<th>Client</th>
<th>MiFID II relevance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Onshore CH</td>
<td>CH</td>
<td>CH</td>
<td>CH</td>
<td>None</td>
</tr>
<tr>
<td>2 Cross-border CH-EU</td>
<td>CH</td>
<td>CH</td>
<td>EU</td>
<td>Indirect</td>
</tr>
<tr>
<td>3 Shared relation CH-EU / EU-CH</td>
<td>CH /EU</td>
<td>CH /EU</td>
<td>EU</td>
<td>Direct</td>
</tr>
<tr>
<td>4 Onshore EU (incl. passport)</td>
<td>EU</td>
<td>EU</td>
<td>EU</td>
<td>Direct</td>
</tr>
<tr>
<td>5 Cross-border / Shared relation CH-Non-EU</td>
<td>CH</td>
<td>CH / Non-EU</td>
<td>Non-EU</td>
<td>None</td>
</tr>
<tr>
<td>6 Cross-border EU-Non-EU</td>
<td>EU</td>
<td>EU</td>
<td>Non-EU</td>
<td>Direct</td>
</tr>
</tbody>
</table>

¹Booking Center; ²Client Advisor
3. Relevance to your business
4. Main areas Swiss investment firms should focus on now

MiFID II will entail challenges which will have an impact on your core business model, what client services and products you offer and your interaction with clients. The table below depicts the key challenges by our definition of MiFID II private banking focus topics and differentiates between product offering and client services.

**Figure 6: MiFID II key private banking challenges**

<table>
<thead>
<tr>
<th>Major private banking topics under MiFID II</th>
<th>Key challenges</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advised services</strong></td>
<td><strong>Product offering</strong></td>
</tr>
<tr>
<td></td>
<td>Independent vs. non-independent advice</td>
</tr>
<tr>
<td></td>
<td>Vague definition of independence</td>
</tr>
<tr>
<td></td>
<td>Ban of inducements</td>
</tr>
<tr>
<td><strong>Inducements</strong></td>
<td>Bank as distributor</td>
</tr>
<tr>
<td></td>
<td>Bank as issuer</td>
</tr>
<tr>
<td></td>
<td>Packaged products</td>
</tr>
<tr>
<td><strong>Third country access</strong></td>
<td>Legal entity set-up and outsourcing</td>
</tr>
<tr>
<td></td>
<td>Organizational requirements and outsourcing</td>
</tr>
<tr>
<td></td>
<td>Scope of passporting</td>
</tr>
<tr>
<td><strong>Execution and OTC</strong></td>
<td>New best execution requirements</td>
</tr>
<tr>
<td></td>
<td>Organizational requirements</td>
</tr>
<tr>
<td></td>
<td>Mandatory OTC clearing</td>
</tr>
</tbody>
</table>

**Advised services**

**Independent vs. non-independent advice**

The current draft proposal foresees that investment firms have to inform their clients about whether or not the investment advice they provide is rendered on an independent basis. Where the client is provided with independent advice, the investment firm will have to assess a sufficiently large number of financial instruments. These will have to be diversified with regard to their type and issuers or product providers. Additionally, the assessment may not be limited to such instruments which are issued or provided by entities that have close links with the investment firm. They will also be prohibited from accepting fees, commissions or any other monetary benefits from third parties in relation to the provision of independent advice to clients.

The requirements for independent investment advice will pose significant challenges for current advisory business models. The loss of revenue streams from third party inducements (e.g., third party commissions) and the restrictions to be expected on cross-selling practices are at the forefront of considerations. Firms will have to make a strategic decision about their advisory offerings by evaluating the competitive advantage of the independent advice, taking into consideration revenue, cost and operational impacts.

Advisory fees for independent advice will likely have to be raised to compensate for the loss of third party commissions. Firms will have to assess their client’s willingness to pay higher fees for independent advice as well as their acceptance of receiving non-independent advice. As a consequence pricing models will need a complete overhaul.
Enhancement of suitability requirements

Evidencing suitability to the client
MiFID introduced the principle that investment firms providing portfolio management or investment advice have to obtain the necessary information regarding their client's knowledge and experience, financial situation and investment objectives in order to make sure that only investment services and financial instruments that are suitable are recommended (suitability test). This framework does not change under MiFID II, however, as an additional obligation, investment firms will have to issue periodic communications to the client in which they must specify how the advice given meets his personal characteristics.

Ongoing suitability
Under MiFID, a suitability test is necessary before the service is rendered (i.e., pre-trade). Under MiFID II, investment firms will have to inform the client on whether they will provide ongoing assessment of suitability. The provision of ongoing suitability is optional, but it could give investment firms a decisive competitive advantage in attracting clients looking for highest quality advisory services. This could become increasingly important in an environment of destabilized investor confidence, however, ongoing suitability will pose serious operational challenges with regard to keeping relevant client information updated whilst monitoring product risk characteristics and possible changes during their circulation in the market. There is also some skepticism among investment firms due to the potentially enhanced legal risks that ongoing suitability may entail.

Narrowed “execution only” exemption
The proposed text’s current practice of execution only will be further restricted. Under MiFID, when providing non-advised services, investment firms are obliged to assess whether the client possesses the necessary knowledge and experience to be able adequately to understand the underlying risks of a product or service, the so called “appropriateness test”. An exemption from this obligation exists if the service relates to non-complex products. The range of products qualifying as non-complex will be significantly restricted under MiFID II, specifically products that embed a derivative component.

Shares and bonds traded on a regulated market (incl. MTFs and equivalent third country markets), money market instruments and shares or units in UCITS will continue to be regarded as non-complex products, only as long as they do not embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved. These products by definition will qualify as complex products and a test for appropriateness will be required.
Inducements and fee transparency

Inducements

The main issue regulators face with MiFID II is to address the possible risk of third party inducements for providers of both investment advice or portfolio management. Inducements may provide incentives for the advisor to recommend products generating higher third party commissions rather than products that are more suitable for the client, representing lower third party commissions.

Ban of Inducements

In order to solve this intrinsic conflict of interest, the EU Commission introduces a ban of third party inducements for providers of investment advice on an independent basis and for portfolio managers.

This ban will not only impact the advisory fee business model, but will be relevant to the entire product selection process for financial institutions. In this context, the fact that in Switzerland the whole range of questions around receiving and providing distribution fees is currently heavily debated adds complexity for Swiss financial institutions. The different treatment of intra-group entity payments between Switzerland and the EEA presents an additional challenge, since the Swiss Federal Supreme Court has not conclusively ruled on these questions.

Fee transparency

Bundling or cross-selling

Investment firms often sell products which are a combination of investment services or financial instruments, also referred to as bundling or cross-selling. The EU Commission does not support the tying of services and products. Accordingly, MiFID II proposes extended information requirements in this area. In the future, “...when an investment service is offered together with another service or product as part of a package or as a condition for the same agreement or package, the investment firm shall inform the client whether it is possible to buy the different components separately and shall provide for a separate evidence of costs and charges of each component.”

Figure 8: Inducements and fee transparency

<table>
<thead>
<tr>
<th>Challenges</th>
<th>Preliminary impact on B / O / P</th>
<th>Relevant questions to be addressed (selected)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Bank as distributor</td>
<td>Low</td>
<td>Impact on product selection process and fee models (e.g. non-monetary)?</td>
</tr>
<tr>
<td>• Bank as issuer</td>
<td>Low</td>
<td>Impact on contractual arrangements with distributors?</td>
</tr>
<tr>
<td>• Packaged products</td>
<td>Low</td>
<td>Transparency requirement similar to KIID?</td>
</tr>
<tr>
<td>• Bank as portfolio manager</td>
<td>Medium</td>
<td>Impact on client servicing fees and investment universe?</td>
</tr>
<tr>
<td>• Bank as advisor</td>
<td>Medium</td>
<td>Impact on client information requirements and investment universe?</td>
</tr>
<tr>
<td>• Bank as custodian</td>
<td>Low</td>
<td>Impact on contractual arrangements with EAMs? / repapering issues?</td>
</tr>
</tbody>
</table>

1B = Business, O = Operations, P = People


2EAM = External Asset Manager
Third country access

Branch requirement for servicing retail and professional clients

MiFID II proposes to introduce a harmonized third country access regime, which will replace the fragmented national approaches existing today. The regime foresees that third country investment firms must establish a branch in a Member State to actively serve retail and professional clients. MiFIR further specifies that activities without a branch are limited to servicing Eligible Counterparties (ECP) only. The specific technical implementation requirements still need to be defined.

European passport for branch services

In order to establish a branch, compliance with certain parts of MiFID II and MiFIR, including the rules of conduct on suitability and conflicts of interest will have to be adhered to. Once a branch has been authorized in an EEA Member State, it will be able to “passport” its services into other EEA Member States. This is currently not possible for third country firm branches.

Generally, the branch requirement will create a substantial market access hurdle for investment firms currently relying on a pure cross-border set-up without an established entity in the EEA. In turn, for investment firms with EEA based entities, the passport possibility might entail an opportunity to streamline their entity set-up, achieving significant cost reductions while still being able to cover their target markets. Whether such European passports include the establishment of additional branches in other EEA states remains unclear. It is likely that an additional license and respective approval procedures will also have to be carried out for all further branches.

High hurdles at governmental level

Branch authorization will also require extensive governmental pre-conditions to be fulfilled at EEA, host Member State and third country level. The EU Commission has to recognize the third country’s regulatory regime to be equivalent. A collaboration agreement needs to be concluded between the home country regulator and the regulator of the host Member State. In addition, a double tax agreement fulfilling OECD standards has to be in place.

Exemption for requested services

The new third country access regime should not prevent persons established in the EEA to receive services by third country firms at their own exclusive initiative. Such services should not be deemed as provided in the territory of the EEA. On the other hand, the exemption is very narrowly defined and will no longer apply once a third country firm advertises its services or solicits clients anywhere in the EEA. It remains to be seen, if relying solely on requested services is a viable option for maintaining a business model without establishing a branch in the EEA.

Figure 9: Third country access

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>Booking center selection</td>
<td>Low</td>
<td>Necessity to book EU clients at branch?</td>
</tr>
<tr>
<td>Promotion of services / products</td>
<td>Low</td>
<td>In which markets shall services / products be actively promoted and clients / prospects be solicited?</td>
</tr>
<tr>
<td>Impact of international agreements</td>
<td>Low</td>
<td>Impact on the Final Withholding Tax Agreements with Germany (incl. “Freistellung”) and UK?</td>
</tr>
<tr>
<td>Legal entity set-up</td>
<td>Low</td>
<td>Need to establish a branch in the EEA?</td>
</tr>
<tr>
<td>Organizational requirements and outsourcing</td>
<td>Low</td>
<td>Outsourcing of services to / from a branch?</td>
</tr>
<tr>
<td>Scope of passporting</td>
<td>Low</td>
<td>Evaluation of passportable services?</td>
</tr>
</tbody>
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Execution and OTC

Best execution

The concept of best execution was introduced in MiFID and obliges investment firms to obtain the best possible result when executing client orders particularly with regard to price, costs and speed. Investment firms have to inform clients on their execution policy, but to date this information provided did not allow clients to verify the firm’s compliance. Under MiFID II, investment firms will have to inform their clients in sufficient detail and in an easily understandable manner how orders will be executed.

Annually investment firms will have to summarize and make public the top five execution venues from the preceding year for each class of financial instruments. Not only are investment firms requested to provide more specific information, the execution venues themselves will newly have to make available to the public data relating to the quality of execution of transactions on at least an annual basis as well. Such data shall be made available in the form of periodic reports including details about price, speed of execution and likelihood of execution for individual financial instruments. All such data must be made available to the public without any charges.

Electronic order recording

Financial institutions will be obliged to record telephone conversations and electronic communications when dealing on their own account and when receiving, transmitting and executing client orders. Records shall be kept for at least three years and provided to clients upon request.

OTC derivatives

In alignment with the G20-commitment that all standardized OTC derivatives contracts should be centrally cleared, and where appropriate, traded on exchanges or electronic trading platforms by the end of 2012, MiFIR foresees that all eligible derivatives will have to be traded on either regulated markets, MTF’s, OTF’s or such third country trading venues approved by the Commission. The trading obligation is foreseen for contracts involving investment firms and also non-investment firms. It will also apply to contracts entered into with a third country counterparty, whereby Swiss financial institutions are also directly impacted.

While investment banking activities will clearly be heavily impacted, possible impacts could also materialize in areas such as OTC structured products distribution, corporate financing or other activities which may also be carried out by wealth management entities. This will depend on the definition of “eligible” derivatives. As MiFIR will be directly applicable upon final approval at EEA level, it could come into force as soon as the beginning of 2013.
4. Main areas Swiss investment firms should focus on now
5. Need for action

Determining where you stand
How Swiss investment firms will have to go about scoping and choosing their approach with regard to implementing MiFID II standards, is largely dependent on their legal entity set-up and the service models they apply. The respective business and operating set-up determines the applicable regulatory regime and thus whether the impact of MiFID II is direct or indirect (e.g. civil law consequences based on the Lugano Treaty). Direct impact can generally be translated to a fully MiFID II compliant implementation obligation. For all other situations a risk based approach as outlined should be explored.

Reducing complexity and achieving clarity
Swiss investment firms should consider MiFID II from both Swiss and EEA perspectives, utilizing a phased top-down approach which outlines the key strategy focus topics to help manage and reduce complexity. High-level gap analysis of the focus topics advised services, inducements, third country access as well as execution and OTC, will further clarify operational implications and requirements for your business. By integrating best practice transformation approach methods from the onset, your investment firm will be in a position to better assess and minimize the adjustments, as well as the effort to implement MiFID II standards and consequently achieve clarity in navigating through the decision-making process. This approach will put you in a good starting position to prioritize effectively and lay the foundation for your strategic and operational decisions. The graphic below briefly explains the MiFID II focus topics.

Identifying regulatory interdependencies
MiFID II touches on many topics that are also in scope of other regulatory initiatives, such as the Dodd-Frank Act in the United States with regard to OTC derivatives regulation or the measures to enhance investor protection published in Switzerland according to the FINMA distribution report. A holistic project approach which identifies interdependent regulatory impacts along functions will help to avoid duplications in assessing and implementing requirements.

Figure 11: MiFID II focus topics

<table>
<thead>
<tr>
<th>Advised services</th>
<th>Third country access</th>
</tr>
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<tbody>
<tr>
<td>▶ Mandatory distinction between independent vs. non-independent advice</td>
<td>▶ Branch requirement for servicing retail and professional clients</td>
</tr>
<tr>
<td>▶ Proof of independence</td>
<td>▶ New organizational requirements apply</td>
</tr>
<tr>
<td>▶ Enhanced requirements to evidence suitability to client</td>
<td>▶ Promotion of products and services</td>
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<tr>
<td>▶ Optional provision of ongoing suitability</td>
<td>▶ Impact on Final Withholding Tax Agreements (Ger / UK)</td>
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</tbody>
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<thead>
<tr>
<th>Inducements and fee transparency</th>
<th>Execution and OTC</th>
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<tbody>
<tr>
<td>▶ Ban of inducements for independent advice and portfolio management</td>
<td>▶ Proof of best execution and publication of top 5 venues</td>
</tr>
<tr>
<td>▶ Enhanced fee transparency</td>
<td>▶ Electronic order recording</td>
</tr>
<tr>
<td>▶ Unbundled offering of packaged services</td>
<td>▶ Mandatory clearing for eligible standardized OTC products</td>
</tr>
</tbody>
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