



SUMMARY OF THE OPEN HEARING ON “RETAIL INVESTMENT PRODUCTS”

Brussels, July 15, 2008

On July 15, 2008 in Brussels, the European Commission held an open hearing on retail investment products in order to shed light on the developments of this critical sector. The initiative took place less than one year after the Market in Financial Instruments Directive (MiFID) regime came into force and raised issues mainly pertaining to five fundamental issues somewhat related to consumer protection and competition: disclosure, conflicts of interest, level playing field, complexity of investment products and regulatory arbitrage.

Charlie McCreevy, Internal Market and Services Commissioner, opened the meeting with some remarks about the retail investment industry. His intervention emphasized the importance of creating the necessary market conditions to give retail investors the possibility to make informed decisions on how to invest their money and to ensure appropriate competition is in place. Mr. McCreevy argued that financial education of investors, disclosure and regulatory measures aimed at securing that brokers and financial advisors act in their clients' best interest are fundamental in maintaining market confidence. He added that users of investment products must understand the instruments they are proposed, and they should be able to trust the financial advisor who makes recommendations. To this aim, conflicts of interest originating in commission-based remuneration should be properly managed and disclosed, and misleading advertisement should be eliminated. Mr. McCreevy indicated three areas in which there is not enough consumer protection: disclosure, conflicts of interest and structured term deposits. Mr. McCreevy concluded his speech by calling for comparable consumer protection throughout the retail investment industry, and backed EU-wide initiatives to monitor the implementation and enforcement of European directives.

The first panel discussed the developments and drivers in markets for retail investment products. Peter de Proft, Director General of the European Fund and Asset Management Association (EFAMA), moderated the debate. Mick McAteer, Director of The Financial Inclusion Centre, affirmed that disclosure is not enough to address conflicts of interest, highlighting the failure of such approach in the British case. Mr. McAteer claimed that competition must be ensured in the offer of products, and criticized MiFID for failing to effectively cope with conflicts of interest. He said the biggest challenge for regulators is protecting consumers while restoring market confidence. Mr. McAteer concluded saying that high levels of return necessarily entail high risk for investors. Giuseppe D'Agostino, Director of Intermediaries Division at CONSOB, underlined the different level of risk of bonds and of complex structured products. He claimed that distributors of structured

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products have the duty to explain the implications of illiquidity and valuation issues linked to this type of financial instruments. Furthermore, Mr. D'Agostino called for a differentiation of procedures when selling structured products and plain vanilla products in order to boost market transparency. Marcin Kawiński, Warsaw School of Economic, Insurance Ombudsman Office of Poland and member of the FIN-USE (Forum of user experts in the area of financial services), claimed that there is a clear difference between mis-selling and conflicts of interest. Conflicts of interest may not lead to mis-selling, but mis-selling systematically originates from conflicts of interest. Kawiński gave the example of banks' employees: motivated to sell bank deposits rather than investment funds because of misalignment of incentives. Brian Reid, Chief Economist of the Investment Company Institute, USA spoke about the American retail market. He said that retail investment in America has a fiduciary duty, and remuneration is based on performance of assets, even though some commission fees are still present. Mr. Reid claimed that innovation is critical in financial products in the face of growing demand coming from retail investors. He also maintained that risk in structured finance may become apparent only many years after the product is issued, and a regime of full disclosure must be in place so that clients are aware of possible pitfalls.

The second panel dug into the issue of whether existing disclosure and point of sale rules deliver adequate levels of retail investor protection. The moderator for the debate was Carlo Comporti, Secretary General of CESR, who opened the debate contending that simplification of information is needed to ensure consumer protection, and called for regulators to check *ex ante* investment products to verify these meet certain standards. Charles Cronin, Head for the Europe, Middle East and Africa region at the CFA Institute Centre for Financial Market Integrity, argued that the Insurance Mediation Directive offers minimum harmonisation of national regulation, and implementation across countries differs significantly. This allows for regulatory arbitrage, which damages consumer protection and market integrity. Mr. Cronin endorsed the creation of a single regime with consistent rules across all markets and financial products. He concluded saying that reputational risks are not enough to address conflict of interest in the financial services industry.

Jean-Baptiste de Franssu, Vice President of EFAMA, stressed the importance of disclosure in ensuring that customers are in the position to make informed decisions. He advocated for greater levels of comparability of information and standardization of disclosure throughout the retail investment industry. He mentioned the Undertakings for Collective Investment in Transferable Securities (UCITS) legislation as being a positive example of sufficient disclosure. However, Mr. de Franssu said there is an uneven playing field because different products are regulated by different directives (UCITS for investment funds, Prospectus Directive for structured products and partially by MiFID and no regulation for structured notes). Mr. de Franssu said that a classification of investment products according to the level of risk should help to make them comparable. He concluded arguing that market forces and regulation must both play a role in improving the market in retail investment products. Gerard de la Martinière, Vice President of the Comité européen des assurances, said that financial education is a key



element in the protection of investors. He added that prudential regulation should play a role too by restraining reckless risk-taking. Mr. de la Martinière argued that consumer protection relies on the quality of the distribution: banks and other sellers of investment products should dedicate enough resources to train, control and evaluate their distributors. Mr. de la Martinière warned that regulation must not change repeatedly to safeguard market stability. He recommended leaving regulation to national authorities, which have a better grasp of local realities. He concluded criticizing the rule-based approach of MiFID on conflicts of interest.

Timothy Hailes, Chairman of the Joint Association Committee on Retail Structured Products, proposed to leave MiFID untouched until its effects are fully felt in European financial markets. He maintained that there is no direct link between complexity and risk, as some panelists had implied. Levels of risk must be fully explained and disclosed with clear and understandable language at the right time in the distribution process. Mr. Hailes defended the structured investment industry claiming that the sector has undertaken a number of measures to ensure full regulatory compliance, and in some instances even going beyond legislative requirements. Nikolaus Neundörfer, Vice President of the European Derivative Association, claimed that codes of conduct are sufficient initiatives to protect investors. These provide for full disclosure of product information, such as risk classification and possible conflicts of interest. Mr. Neundörfer praised self-regulatory frameworks and asserted that structured securities are different from investment funds. Guido Ravoet, Secretary General of the European Banking Federation, affirmed that banks play an important role in distributing investment products, and it is in their interest to protect their customers. Banks should be close to their clients and fully understand the products they sell. Mr. Ravoet considered MiFID as being a good piece of legislation, and claimed that it should be the benchmark for investor protection. Because banks' business is all about confidence, Mr. Ravoet recommended that the industry takes considerable steps to enhance financial education. He concluded noting that the market in investment product is still fragmented.

Following the lunch break, Theodor Kockelkoren, Member of the Executive Board of the Netherlands Authority for Financial Markets (AFM), delivered a presentation in which he analyzed the Dutch market for retail investment products. He argued that uneven playing field for financial instruments negatively impact the market, and called for regulation to allow consumers to make good decisions with adequate financial advice. For instance, insurance investment products and investment funds are regulated differently on diverse areas such as taxes, transparency, inducements and duty to care. AFM has leveled the playing field by regulating insurance products similarly to other investment instruments. Mr. Kockelkoren reported that investment advice is improving in the Netherlands but still 25% of surveyed institutions were not providing adequate investment advice. Mr. Kockelkoren spelled out several principles he wished to see implemented across Europe: name reflects content; qualitative explanation; description of underlying value; description of structure and features; example of how the product works; description of expected value in a good and a bad scenario. He concluded saying that some synthetic



risk indicator, a clear indication of cost and expected return in different scenarios should complete the product's portrayal.

The third and last panel discussed whether the extant EU legislation regarding retail investment products is fit for purpose or in need of improvement. David Wright, Deputy Director General of DG Internal Market and Services, European Commission, moderated the panel. Dan Waters, Head of the Asset Management Sector at the UK FSA, pointed out how retail investment products are sold in separated national markets and no significant cross-border transaction takes place. He underlined that important information about investment products must reach the customer at the right time, and how this is implemented across Europe does not matter. The retail investment market, Mr. Waters claimed, has two fundamental features: customers do not hold enough knowledge and competence to judge their purchases; distributors' incentives are misaligned in reason of commission-based remuneration. He described the current regime in the UK where there is a clear distinction between the sale and the advice department in the distribution of financial products, the bar for investment advisors is set high and commission-based compensation is limited in order to restrain providers' influence on sellers. Moreover, Mr. Waters recommended that supervisors engage in risk analyses on new financial products and that they put in place requirements for distributors to handle and address customers' complaints. He also stressed the difference between structured products and structured deposits, the latter category not being covered either by MiFID or FSA regulation. Finally, Mr. Water argued that only market developments rather than regulation can create a truly European market for retail investment products.

Giovanni Cucinotta, Head of Research Department of ISVAP and Member of the Management Board of CEIOPS, highlighted that insurance products are not exactly equivalent to pure financial products, contending that there is no uneven playing field for these two categories. Mr. Cucinotta deemed existing levels of disclosure for insurance products under the Life Directive and Insurance Mediation Directive to be adequate for consumer protection. He concluded his intervention stressing the importance of providing less, more direct and clearer information on financial products. Kersting af Jochnick, Chair of CEBS, regarded information on investment products to be a critical element in establishing and maintaining market confidence. To this regard, af Jochnick indicated that CEBS had correctly moved in this direction by producing two papers on transparency and valuation of illiquid assets. Moreover, she emphasized the importance of educating consumers, investors and market participants in order to understand all the financial implications of their actions. For this purpose, national legislators should establish school schemes in financial education. Mrs. af Jochnick said that CEBS was cooperating with CESR and CEIOPS in establishing standards for consumer protection, even though the majority of market participants believed that the issue was properly addressed by the current regulatory framework. She argued that consumers need good, comparable information before they buy investment products, and this is valid across banking, insurance and security markets. Additionally, she said there is no agreed definition of "deposits," which makes it not clear whether structured deposits fall under MiFID. Finally, Mrs. af Jochnick encouraged the retail investment industry to set up



cross-sector initiatives to improve in the areas of consumer protection and market transparency.

Eddy Wymeersch, Chairman of CESR, argued that there is a link between investor protection and financial stability. He affirmed that IPO prospectuses are too long and complex, and they should provide less information but clearly indicating where risk lies. In addressing conflicts of interest, Mr. Wymeersch regarded “suitability” as the guiding principle to tackle the issue, adding that the fiduciary duty should be included in the discussion. Moreover, he said that the same principles rather than the same legislation should be in place to battle against conflicts of interest, but this must not lead to regulatory arbitrage. Mr. Wymeersch believed that insurance products are managed like portfolios: they should therefore fall under the MiFID regime. Additionally, he considered the inducement regime in MiFID to be a success, even though there were concerns that it was implemented unevenly across markets. Mr. Wymeersch also stressed the importance of collecting data on the differences and dynamics in national retail investment markets so that we could better grasp how to intervene. He concluded his speech by calling for a principle-based centralized regime on retail investment products and said that in spite of the importance of this issue, consumer associations were not sufficiently attentive. Jiri Krol, Director of Financial Market Analysis and Development Department, Czech Ministry of Finance, argued that the regulatory patchwork following uneven application of MiFID rules poses a problem in terms of competition in retail investment services. He called for major efforts in implementation and enforcement of present regulation rather than a mere focus on legislation. Mr. Krol also mentioned the inducement regime in MiFID to be a small revolution with positive repercussion on market transparency. As far as structured deposits are concerned, he argued that they should be covered by MiFID in order to provide appropriate consumer protection. Mr. Krol maintained that conflicts of interest arise because distributors of investment products engage in researching and advising services as well, leading to market distortions. For instance, investment advisors tend to recommend products where they get the most commission, Mr. Krol said. Finally, he believed regulators should be independent but also accountable to elected officials.

Thierry Francq, Chef de service, Service du financement de l'économie, Direction générale du Trésor et la politique économique, Ministère de l'économie, de l'industrie de l'emploi, closed the open hearing on retail investment products with some final remarks. Mr. Francq claimed that consumers should be represented in investment product debates, since this market is growing rapidly. The simple question, he said, is whether MiFID should be extended to insurance products. Mr. Francq asked what the ideal remuneration structure to establish market transparency is. He strongly advocated for a solution at the European level because of the need of a common market. Moreover, Mr. Francq argued that market developments are going to lead in that direction thanks to MiFID, most notably with the European “passport” of financial services. He also added that European directives must create innovation and be forward-looking rather than close loopholes and remedy to market failures. He called for collection of data on different market structures to provide a basis for regulatory initiatives. Mr. Francq concluded affirming that financial



innovation is fundamental, but it must be sustainable, useful and rooted in sound principles.

Piero Cinquegrana