

# How does retail investor protection contribute to financial stability and what measures are required in priority?



## 1. Investor protection plays a major role in financial stability:

**Investor protection rules comprise a variety of requirements covering the main steps of the investment value chain** - product regulation, rules to preserve market integrity, the regulation of selling practices and of the information provided to investors - and can be completed by deposit guarantees, financial education programs and dispute resolution schemes. **They play a major role in developing investor confidence and facilitating investment strategies adapted to the needs of customers and should lead to more efficient capital markets that are more reliable and trustworthy in the eyes of investors.** Such rules complete prudential requirements relative to the solvency and liquidity of individual companies and capital market regulation and are thus essential in favouring financial stability.

The regulation of selling practices and investor information indeed aims at reducing the potential information asymmetry and market power imbalances between the industry and investors on one hand and between product providers and distributors on the other hand, which are encountered particularly with fairly complex or innovative investment products. They also reduce potential incentives for mis-selling by helping to clarify conflicts of interest and the costs borne by investors.

Such rules reduce possible mismatches between investor expectations and the real features of investment products and facilitate trade-offs between financial products by encouraging financial players to provide sufficient information and ensuring that sales processes include an adequate level of advice. This should help to improve the allocation of savings to appropriate investment products leading to more stable and efficient investment patterns. In the same way the supervision of market conduct completes the macro and micro supervision of market players and markets in making sure that investor protection measures are fulfilled.

Product regulations complete the regulation of selling practices and of investor information by ensuring that appropriate standards of risk, liquidity, diversification... are applied consistently by producers, with the objective of avoiding opaque, illiquid or inappropriate products developing in the market.

## 2. Proposals have been developed by the Commission to improve pre-contractual disclosure and selling practices for packaged retail investment products (PRIIPs)<sup>1</sup> answering similar investment needs:

**The financial crisis recently highlighted the importance of investor protection rules and the major role they can play in preserving financial stability.** The present crisis indeed finds its origins to a large extent in deficiencies in consumer protection and insufficient market conduct rules in the US which facilitated the sub-prime crisis.

Some investor protection problems were also experienced during the crisis in the EU but not with the same magnitude as in the US (which can probably be explained by a more complete set of protection rules in different areas): for example the counterparty risks borne by structured products issued by Lehman Brothers which had been sold to retail investors directly or within

wrappers in different EU countries or liquidity and transparency problems experienced by some money market funds invested in asset-backed securities.

The role played by consumer protection in reforms required in the financial system is clearly acknowledged in the US, with the decision to create a Consumer Financial Protection Bureau, which is mostly focused on credit products at this stage. Proposals have also been made regarding the protection of investors, to be implemented by the SEC in particular.

**The Commission has committed in its 2009 communications to making legislative proposals in the EU in order to improve the protection of retail investors, notably by means of the PRIIPs (Packaged Retail Investment Products) initiative.** The PRIIPs initiative was proposed by the Commission to improve retail investor protection, building on the progress made with MiFID, IMD (Insurance Mediation Directive) and the UCITS KID (Key Investor Document) and to address level playing field issues in the EU legislations that apply across the different sectors and product categories in the retail investment market (ie investment funds, unit-linked life insurance, structured securities...). The Commission noted evidence that investors find difficulty in understanding and comparing many of the investments offered to them, and observed that those selling these investments are potentially subject to conflicts of interest.

**The Commission concluded that the existing European legislation was not sufficiently coherent to address these issues: the current landscape is a "patchwork" of regulations setting different standards depending on the legal form rather than the economic function of the products.** The financial crisis has underlined the importance of these issues, though the PRIIPs initiative predated the crisis.

## 3. While the objectives put forward by the Commission are quite clear, the appropriate legislative approach of the PRIIPs initiative needs to be fine-tuned:

Although most stakeholders agree with the value of improving the coherence of EU investor protection regulation and accept the concept of a horizontal approach covering the main types of retail investment products, as proposed by the Commission, at least for pre-contractual disclosure, many industry players point out the risk of creating overlaps with existing legislation and the need to build on best practices: not only MiFID and the UCITS KID which have been pinpointed by the Commission as intended benchmarks for the content of the sales and disclosure rules but also the IMD directive. Future legislation should also take into account the specificities of the products covered and distributors concerned (indeed distribution models and statutes differ to a certain extent across products and EU countries).

**Generally speaking, the lack of comparability of pre-contractual disclosure for products answering similar investment needs and the complexity and insufficient clarity of existing product information, often conceived as legal and technical documentation, are major concerns that need to be addressed as a priority.** Clear and comparable pre-contractual information (e.g. on product features and related risks) can indeed to some extent help retail investors in their decisions and limit poor

1) PRIIPs comprise mainly investment funds, unit-linked life insurance and structured products



investments. Improvements in this area would also facilitate the work of intermediaries in downstream stages of the value chain (ie distribution and advice activities). In addition, a horizontal legislative approach seems well adapted to this objective since common templates, criteria and classifications can potentially be defined for PRIIPs, but these need to be developed so that the specific features and risk / reward profiles of different products are well communicated and overlaps with existing disclosures avoided or addressed.

**Adapting distribution rules in a horizontal way seems more complex at this stage.** Many observers indeed believe that although the high level principles of MiFID and the IMD are coherent and can be used for guidance in defining horizontal legislation in this area neither of these texts can be easily applied to a broader product scope in their present state, when taking into account implementing legislation. Rules for mitigating conflicts of interest for example are approached differently as well as requirements with regard to advice.

**A more realistic alternative for distribution rules in the short term could be to seek to improve the coherence of existing requirements within MiFID and the IMD, as well as their capacity to ensure appropriate protection of retail investors in PRIIPs products, while keeping these as separate texts. This could be done on the occasion of the review of these texts in 2011.** In this perspective, solutions for mitigating conflicts of interest and requirements for the advice provided by financial intermediaries should

be specific areas of focus, as well as measures to ensure that product information flows easily and effectively from producers to investors through intermediaries. The best practices of MiFID and the IMD should be capitalized upon, although more hindsight with these directives than is presently available might be needed in some cases. This approach could also help to better evaluate the possible added-value horizontal measures could have for distribution rules and their feasibility.

Attention should also be paid to existing or projected domestic initiatives regarding investor protection when developing future EU legislation. Sufficient coherence across investor protection legislations at EU level is indeed necessary for facilitating sales of cross-border investment products and going towards further integration of the EU market.

Some players believe that deeper thought could also be given to clarifying the respective roles played by distribution and product regulation for certain product categories and to identifying possible gaps in retail product regulation (which is not addressed in the PRIIPs initiative). Structuring actions to increase the financial literacy and awareness of investors and to improve requirements for financial advisors has also been proposed by some observers as part of longer term objectives to improve investor protection, as well as reviewing the scope and content of supervision with regard to investor protection and financial education.

