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"Packaged" Retail Investment Products

Draft Position paper following
The European Commission "PRIPs" Workshop, Brussels, 22 October 2009

Executive Summary

* We strongly support the new "horizontal" approach of the EC, which is the right way to look at the distribution of retail investment products, as most of them are "substitute" to each other, and most of them are or can be sold by the same intermediaries.

* We nevertheless regret that the retail investor's perspective is not enough taken into account. The statement that retail investment "*is currently largely channeled through packaged retail investment products*" is not accurate, and does not reflect the reality at the point of sale. All substitute retail investment products at the point of sale must be included, or we strongly believe the Commission would be unfortunately wasting its time and efforts to adopt a horizontal approach, **but limited to a rather small and artificially defined section of the substitute retail investment products (SRIPs) market**.

* The "KID" (Key Information Document) for UCITS investment funds should serve as a reference for the **pre-contractual information** of other retail investment products.

* We agree with the Commission that the MiFID **selling rules** should apply to all substitute retail investment products, especially the "inducement" rules which seem to be unfortunately quite unevenly enforced. It is therefore crucial to combine this legislative reform with the MiFID 2010 revision process.

* Finally, we would like the Commission to explore perhaps bolder alternatives:

- Allow selling of "complex" products only by licensed and qualified intermediaries, and only to licensed and qualified investors. These licenses would be based on reaching a minimum level of financial literacy.

- Or consider banning distributors commissions (already in place in some member states and currently considered in the UK), and label financial products, including with a "toxicity" label.

As the Commission rightly puts it: "*the collapse in retail investor confidence during the financial crisis has given new prominence to the Commission work on level-playing field and investor protection issues in the retail investment market. Retail investors often poorly understand the risks, costs and features of investment products, and those selling these products can be subject to significant conflicts of interest. Also, existing rules on information for prospective investors and the conduct of those selling to them form a patchwork that exposes significant gaps and inconsistencies in approach depending on the legal form of a product (rather than its economic nature).*"

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The Commission has been working on preparing the ground for detailed legislative proposals.
The 22 October 2009 workshop forms a part of this ongoing work, offering an informal chance to discuss and consider some of the key issues that will need to be faced, focused on:
– the scope of the work (which products should be covered);
– requirements on pre-contractual product disclosures (the development of consumer friendly 'key information documents' (KIDs) for all "PRIPs"); and
– requirements on sales (ensuring the same high consumer protection standards apply to all sales).
The Commission welcomed written contributions from the workshops participants. We are happy to communicate the present contribution.

1. **Scope of "PRIPs"**

We congratulate the EC for this "horizontal" approach, which is the right way to look at the distribution of retail investment products, as most of them are "substitute" to each other, and most of them are or can be sold by the same intermediaries. We recognize it is innovative and challenging for the EC to cut through existing organigrams and directives.

We nevertheless regret that the retail investor's perspective is not enough taken into account. The statement that retail investment "*is currently largely channeled through packaged retail investment products*" is not accurate, and does not reflect the reality at the point of sale. For example in France the majority of retail investment products is not "packaged": bank saving accounts, traditional life insurance contracts, plain vanilla investment funds, equities and bonds constitute the vast majority of retail investments.

We strongly regret that the initial name of the project – **"substitute"** investment products – has been discarded without any explanation for the much worse and much narrower **"packaged"** investment products name. Investors do not care at all whether an investment product is "packaged" or not and do not know its meaning anyway. The Commission has consequently excluded the vast majority of substitute retail investment products for no explicit reason. "SRIPs" are relevant for the investor, not "PRIPs"

Therefore, we do not believe the criteria outlined by the Commission are able to capture the relevant market for PRIPs:
- products packaged or not can still be substitutable to each other: example: an equity investment fund is substitutable to a portfolio of equities. In that sense, an investment fund is certainly a "packaged" form of underlying financial assets.
- from the point of sale perspective it often does unfortunately not really matter whether the product was "designed with the mid- to long term market in mind", what matters is how they are sold. Experience show that intermediaries and retail investors use products that are designed with a short term market in mind for mid- to long term purposes (example: the switch from life insurance to bank savings accounts in France in Q4 2008 when the latter yielded 4,50 % tax free, and the reverse move from Q2 2009 when the latter's yield dropped to 1,25%).

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- one criterion is missing: the investment product must be subscribed on an individual basis and not mandatorily (this distinguishes personal long term savings and pension plans with collective and mandatory ones, the latter not being substitutes to other retail products for that reason).

All substitute retail investment products at the point of sale must be included, or we strongly believe the Commission would be unfortunately wasting its time and efforts to adopt a horizontal approach, **but limited to a rather small and artificially defined section of the substitute retail investment products (SRIPs) market**. Regulatory arbitrage would likely be very widespread, which is what the EC wanted to avoid in the first place.

Therefore, huge portions of SRIPs are missing in the indicative list of included products, notably but not limited to:

- Shares (for example preferred shares can often be looked as a substitute to long term bonds or even annuities),

- Bonds (especially banks EMTN massively sold as high yield substitutes to savings accounts at the point of sale)

- Traditional life insurance (for example the € 1100 billion invested by French households in "euro contracts", by far the most popular long term investment product there: it is neither unit-linked nor index-linked or hybrid). these products which are being substituted to savings accounts, investment funds, long term savings plans, bonds, etc.

- Savings accounts; all SRIPs include "investment risk", even traditional insurance and bank savings accounts (for example the risk of fluctuating interest rates).

- Individual pension and annuity products, which again are totally substitutable to other SRIPs offered to individuals; as long as the products can be subscribed individually and purely on a voluntary basis, they must be included (e;g. "PEE", "PERCOs", "PERPs" in France, all "Riester" Plans in Germany.

- Derivatives, as long as they are often sold to retail investors (like warrants and CFDs), these are SRIPs: therefore they should be included.

2. Pre-contractual product disclosures

We would first like to congratulate CESR for the tremendous work It has been putting behind the design of the "KID" (Key Information Document) for UCITS investment funds.
This Kid should serve as a reference for other retail investment products. For example, the quality of the current prospectus summary for securities (shares, bonds, EMTNs, etc.) is appalling. It is not formatted at all, the language is not investor-friendly, and often the key information is missing

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(like the interest rate for EMTNs).

The key principles behind the KID should apply to all SRIPs:

- harmonized format and vocabulary,
- maximum size,
- comparability,
- recommended time horizon, etc.

Some industry representatives would argue that some products are too complex for this approach. If they are too complex, then they should be sold only to qualified investors. The financial crisis has shown that financial products were sometimes too complex to be really understood, not only by investors, but also by financial intermediaries, and also by banks (e.g. the risk of securitized subprime loans). At the core of the crisis, a lot of voices including in the industry (e.g. the CEO of Goldman Sachs) asked for less complexity and a return to basics. It is unfortunate that these calls seem to have quickly been forgotten by regulators.

Structured products

Also everyone should be clearly aware that complexity is often a means to hide the remuneration of the providers and the low probability of future performance. As a matter of fact, so-called "structured" products are designed and sold primarily for retail investors. The ETF market leader itself notes that structured ETFs were designed for the retail market only to allow for paying commissions to intermediaries, while "transparent", simpler ETFs were aimed at institutional investors[1]. Warren Buffet himself advises to invest only in products one understands.

Even "structured" UCITS funds will be covered by the KID requirement, although we regret that CESR did not follow through on the probability tables approach for performance disclosure. Studies show that overall, "capital guaranteed" funds for example had a high probability of underperforming the equivalent risk free rate. The "performance scenarios" option retained by CESR will not inform and warn investors about this serious issue.

Performance

Among key areas in which comparisons are important for investors, past performance is often misleading (studies have even often shown a negative correlation between funds performance for a given period of time and performance for the subsequent period) and can be easily manipulated. For example a common trick done by many big investment houses is to launch three similar funds at the same time, not market them for three years, and then retain only the top performing one to market a very "sellable" three year track record.

Whenever past performance is disclosed, it is very important to require the disclosure of the relevant comparable indicator of reference as mentioned by CESR for the UCITS KID. Especially it must not be misleading like, for example, using a "price" index (without dividends) for a product that capitalizes dividends. This very misleading practice is unfortunately widespread nowadays.

[1] See annex 1 : BGI's interview 08/09/2009

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Costs

Another key area for comparison is costs. We deeply regret that CESR has not retained our demand to give a cash example. All surveys show that retail investors understand cash figures much better than percentages. Also, it is the only way to clearly combine the impact of ongoing charges on assets with entry and/or exit charges on investments/redemptions. Finally, this cash example has been used for decades for all US domiciled funds without any of the supposed issues raised by the European financial industry against this cost transparency tool.

It is also very important to disclose the consolidated cost born by the investor. This will eventually be done with the enforcement of the KID for UCITS (a fund of fund will have to disclose the consolidated cost adding the two layers of costs). For other substitute products like life insurance contracts, there can often be three layers of costs, and only the top of the costs iceberg is currently disclosed. For example, currently unit-linked insurance contracts (which are "wrappers") disclose only the charges of the contract itself, not adding the charges on the underlying "units" (most often funds). This is grossly misleading; showing for example a 1% annual charge instead of 3 or 4% in reality when one adds the charges paid by the units. FAIDER in France had obtained that these costs be consolidated for French domiciled life insurance contracts in 2004. But this investor friendly regulation has been suppressed in 2006.

3. Selling practices

We agree with the Commission that the MiFID principles should apply to all substitute retail investment products. It is crucial to combine this legislative reform with the MiFID 2010 revision process.

One should not overestimate the legal and technical challenges of this extension. For example, some principles of MiFID are already being extended to life insurance products (fair information, advice) mostly merely through a "copy-paste" of the MiFID and of the MiFID execution Directive to the local insurance code (this is part of the "Credit à la Consommation" law already adopted by the French Senate, and under discussion at the French National assembly).

Conflicts of interest

Again, MifID principles should be enforced and applied to all substitute products in that area.

We refer to our comment above and to Annex 1 for "structured" products: the compensation for the providers is totally hidden there, and this is one reason to "structure" the product in the first place, as explained by the ETF industry leader (annex 1).

We also raise doubts about the current enforcement of MiFID in that area; Even CESR did not mention anything on inducements and on the mandatory disclosure of commissions received by intermediaries from providers in its "Consumer Guide to MiFID", despite the official request of FIN-USE[2].

[2] See FIN-USE Letter to CESR concerning the Consumer's Guide to MiFID *(24.5.2008).* Also to be found in FIN-USE 2008 annual report.

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Also, there are often severe tax discriminations against more transparent financial products selling practices. For example, in France, fee-based advisors (paid by their clients) are discriminated as their fees are not tax deductible for the investor, whereas commissions paid by providers are de facto deducted as they are funded by the management fees charged on the product by the manufacturer.

Also "movement" commissions, which are widespread in France for example, should be banned: these are commissions paid by custodians to asset management companies for securities transactions. This is of course an incentive to increase the turnover of the product's portfolio at the expense of investors. Needless to say such a practice goes against the MiFID "inducements" provisions.

Finally, we would like to propose that the Commission explore and research other tentative alternatives:

- Allow selling of "complex" products only by licensed and qualified intermediaries, and only to licensed and qualified investors. These licenses would be based on reaching a minimum level of financial literacy.
- Or ban distributors commissions (already in place in some member states and currently considered in the UK)[3], and label financial products, including with a "toxicity" label. In the body health area, prescribers (doctors) don't usually get commissions from drug providers, and the regulators may label products according to their effectiveness and also to their toxicity. That is because drugs and therapies are often too "technical" for consumers to choose by themselves. Why not extending these practices to the "financial" health area if it is eventually decided that products and services are too complex and technical for the average consumer to grasp? It is up to the financial industry to decide: in short, back to basics, or face the appropriate regulations for potentially (financial health) endangering products.

[3] We would have serious concerns on this option however if it would ever result in the elimination or the reduction of independent financial advisors' role, as IFAs and the like are still more transparent and have less conflicts of interests than the big integrated bank or insurance networks.