

CALL FOR EVIDENCE

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NEED FOR A

COHERENT APPROACH TO PRODUCT TRANSPARENCY

AND DISTRIBUTION REQUIREMENTS FOR

"SUBSTITUTE" RETAIL INVESTMENT PRODUCTS?

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EUROPEAN COMMISSION

DG MARKT – G4

CALL FOR EVIDENCE ON "SUBSTITUTE" RETAIL INVESTMENT PRODUCTS

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EXECUTIVE SUMMARY

Investment products offering comparable risk/return performance can be sold in a variety of forms. Households and private investors already rely heavily on these different forms of product to meet their financial needs. This dependence is set to grow as individuals turn to private pension products to help them to provision for retirement. Effective product disclosures and increased professionalism in financial distribution will be vital in ensuring a successful transition.

EU legislation applying to the institutions originating these products imposes different levels of product disclosure (for example, on risks, charges and rewards) and different rules on the way that financial intermediaries must conduct business with retail clients, and manage any conflicts of interest that might arise.

This sectoral approach was inherited from a period when retail financial products had distinct profiles (for example, insurance, investment, saving) and were largely distributed through separate distribution channels. The blurring borderline between investment products and the opening architecture in EU financial distribution pose new challenges for this regulatory system.

This call for evidence focuses on whether this fragmented regulatory landscape leads to unacceptably high variations in the level of product disclosure and investor protection, depending on the regulatory status of the investment product. It does not call into question differences in the rules governing the authorisation or prudential supervision of the institutions which originate these products. These institutions employ different financing methods and incur different types of risk, which need to be

taken into account in the relevant prudential frameworks.

This call for evidence does not imply a preference in favour of, or negative judgement against, particular forms of investment product. Competition between products is a positive and healthy development. It broadens the range of options available to investors and increases the likelihood that they will find a product to match their needs. However, innovation in the structuring of retail investment products should be accompanied by a sustained commitment to clear disclosures of expected investment performance, and effective management of conflicts of interest – irrespective of the legal form of the investment proposition. Investment propositions should not be packaged so as to circumvent inconvenient disclosure and regulatory requirements for the product originator or intermediary.

The Commission services would like to emphasise at the outset that there is no a priori view that a significant problem exists. The main purpose of the call for evidence is to establish whether there is a real and significant – as opposed to perceived or theoretical – risk to investor protection resulting from the different levels of product disclosure or intermediary regulation embodied in EU financial services legislation. To this end, the Commission services would welcome evidence-based responses to help us to better understand whether or not there is a significant risk of investor detriment that needs to be addressed.

To the extent that regulatory considerations – as opposed to other differences in the operating environment arising from tax treatment, inertia in

distribution systems etc – are viewed as giving rise to risks to investors, we invite views on the areas that may require attention. As a starting point, this call for evidence asks which investment products should be taken into consideration. Then, the call for evidence identifies four possible areas for investigation (there may be others): (1) product disclosures; (2) conflict of interest management by product originators and intermediaries; (3) point of sale rules to be respected by intermediaries to limit the sale of 'unsuitable' products; and (4) rules on advertising/marketing.

The call for evidence also invites views on whether – if significant risks are considered to exist – corrective action is needed. Are market forces and reputational risk, possibly supported by self-regulatory measures, sufficient to drive transparency and discipline in distribution networks? If regulatory action is required, can (coordinated) action by national authorities deal effectively with problems in often local distribution franchises? Is EU level involvement required? Again, the Commission takes no a priori view on these questions. It is looking for clear evidence based on submissions to help it to form a clear view on the existence of any problem and how it manifests itself, before proceeding with reflections on the type of solution that might be needed.

Next steps

The need to sustain investor confidence in the multi-trillion EU retail investment market is beyond doubt. We need to ask ourselves whether the current regulatory patchwork governing product disclosure and intermediary regulation is capable of sustaining that confidence. This call for evidence is a first step in developing a

basis to respond to these strategic questions.

On the basis of responses to this call for evidence and other inputs, the Commission will – in the autumn of 2008 – issue a Communication with its assessment of whether corrective action is needed and identifying possible forms of proportionate response.

PROCEDURE

Reactions to this call for evidence should be sent to the following e-mail address: markt-consult-substiprod@ec.europa.eu, by 18th January 2008, close of business at the latest. Requests for clarification on specific questions should be sent to the same mailbox. A feedback statement summarising the replies received will be published in March 2008.

All replies will be made public via the European Commission website: http://ec.europa.eu/internal_market/finances/cross-sector/index_en.htm, except for respondents who do not want their reply to be published. In such cases, they are asked to state this clearly in their reply.

CALL FOR EVIDENCE

INTRODUCTION

Why a call for evidence on substitute investment products? This topic is the subject of increasing attention at national, European and global level. It stems from perceptions that varying levels of investor protection embodied in different families of financial legislation may expose retail investors to different risks. In particular, there is a concern that some products may be sold without adequate disclosure of fees and charges or the range of investment outcomes. There is concern that conflicts of interest may influence the range of investment products to which retail investors have access, and that investors may be sold products which are 'unsuitable' for their profile. There is also a fear that less transparent or regulated products may be easier to sell, thereby displacing more heavily-regulated products and exacerbating investor protection concerns.

On May 8th, EU Finance Ministers invitedⁱ the Commission "to review the consistency of EU legislation regarding the different types of retail investment products (such as unit-linked life insurance, investment funds, certain structured notes and certificates), so as to ensure a coherent approach to investor protection and to avoid any mis-selling possibilities."

Regulators are also increasingly attentive to the issue. The three "Level 3 Committees" (CEBS - Committee of European Banking Supervisors; CESR - Committee of European Securities Regulators and CEIOPS - Committee of European Insurance and Occupational Pensions Supervisors) have undertaken an initial review of national rules governing product disclosure and intermediary

regulation for different financial products. This initial assessment led to the conclusion that "*relatively many (supervisors) face challenges regarding the un-level playing field from the point of view of competition and investor protections*".

At international level, the Joint Forum of regulators (Basel Committee of G-10 banking supervisors) is investigating the impact of different approaches to product disclosure and intermediary regulation on the sale of retail financial products and services.ⁱⁱ Its report is scheduled for publication in January 2008.

The issue is also gaining currency in the European Parliament. The (draft) own initiative report on asset managementⁱⁱⁱ "[...] requests, in this context, a review of the legislative framework on the marketing, advice and sale of all retail investment products by the end of 2008 at the latest, [...]".

Consumer representatives are increasingly voicing their concerns^{iv}. In their response to the recent Commission Green Paper on retail financial services, BEUC^v proposed that "*the same level of information should be granted for products meeting the same needs*".

There is therefore a widespread perception that inter-product regulatory differences may threaten investor interests and distort markets for retail investment products. The European Commission believes that these concerns warrant further scrutiny. There is a need to assess whether there is substance to the perception that differences in the regulation of product transparency or distribution may leave investors exposed to risks of over-charging or being sold unsuitable products.

This call for evidence seeks to gather opinion and evidence in order to allow the

Commission to submit an informed assessment of the situation to the Council and European Parliament. This consultation process should be seen in conjunction with the Communication on financial education and the Green Paper on retail financial services.

The structure of the present document is as follows.

Section 1 focuses on the scope of the review and explains why concerns of investor detriment in relation to substitute products are emerging, describes some of the substitute products that could be considered within the scope of this exercise, and seeks input on the factors driving the promotion and sale of particular products.

Section 2 asks whether varying information disclosures or distribution regulations lead to investor detriment. It invites comment on the management of conflicts of interest within distribution channels. It tries to establish whether there is evidence of the sale of investment products to investors for whom they are not suitable, and to determine whether there is substance to fears of mis-selling or misleading advertising for certain products.

Section 3 raises the question of the possible need for action to address risks arising from uneven product disclosures or sales and distribution regulations that contributors might identify. If such a need exists, would action by market participants be sufficient? Or is there a case for public authority involvement, at national or EU level?

1. Scope of the review

1.1. *Why are concerns of investor detriment emerging?*

Huge volumes of savings are invested in EU retail investment products. Values invested through retail investment funds, unit-linked life insurance products and retail structured products amount to more than €10 trillion ([Annex 2](#)). Net sales are close to € 500 billion a year.

EU Directives currently applicable to financial and insurance products were designed - prior to the introduction of the Financial Services Action Plan in 1999 - for a landscape in which a variety of functionally distinct products were offered, through specific distribution channels, to retail consumers with different objectives. An investor could choose deposits on bank accounts, or invest directly in relatively simple securities, such as shares or bonds held on an account at his/her bank. He/she could also buy units of an investment fund (generally managed by a company belonging to the same group as his/her commercial bank). Additionally, a client with objectives other than to simply maximise return on investment (for example, to pass assets in a tax-efficient manner from one generation to the next, or from an insured person to a beneficiary different from his/her legal heirs) could buy a life insurance policy offered by an insurance company. These products delivered distinct tax treatment and investment performance and were sold through separate distribution channels.

The range of investment products available to retail customers has since evolved considerably. Today, a retail saver with the economic objective of saving money for the relatively long term and maximising the potential return, can be

offered a tailored solution ranging from investment funds to unit-linked life insurance products, annuities, term deposits, structured products or others by the same distributor.

1. Financial products are much more complex: derivatives are increasingly used to leverage or hedge exposure to targeted financial markets. Thus a bond can be structured so as to respond to a specific economic objective, similar to that of investment funds. In the banking system, the capital gain or income on term deposits no longer stems simply from exposure to interest rates but now also to broader instrument markets. They offer different profiles, maturities and purposes to match different investor needs.
2. By and large, the borderlines marking the distinction between some financial, banking and insurance products are becoming increasingly blurred, whereas the range of mid- to long-term investment products available to retail customers is continually broadening. An increasing proportion of life insurance policies are invested in underlying investment funds (34.3% in 2006; 24.2% in 2005 and 22.2% in 2004 - see Annex 2 section [B.2.](#)) and in some cases encompass a very limited, or no, life dimension.
3. The use of "wrappers" is increasing. Underlying performance is harder to discern. The same investment proposition can be wrapped in different forms and sold through a variety of distribution channels to retail customers. Retail investors familiar with a particular wrapper or distribution channel may be presented with relatively novel,

complex and non-transparent investment propositions.

In a context where individuals and households are assuming greater responsibility for retirement provisioning and long-term financial planning, investor confidence in investment products as well as in their originators and distributors is crucial. This often entails taking out personal pension schemes, to complement state or occupational pension schemes. In so doing, investors demand investment products that not only allow them to maximise returns over the contribution period, but also deliver a regular income during the benefit period. Financial, life insurance, banking and other investment products compete to meet this demand.

Distribution channels are less and less specific to particular products. Banks offer financial products in addition to traditional banking products and often extend their range to include insurance products. Insurance brokers have also extended the range of the products on their shelves, by diversifying into financial or banking fields. In the context of open architecture^{vi} or guided architecture, distributors no longer offer only proprietary products but promote a broader range of third-party products. Intermediaries are able to pick and choose between larger ranges of products. This is positive but there is a need to ensure that the selection of products is driven by concerns to provide suitable and attractive products to end investors.

Competition between products is undeniably a positive development for retail investors, who are now able to select from a wide range of products to meet their investment needs. However, the EU regulatory framework has failed to keep pace with this shifting landscape. Different EU regulations apply to the marketing and/or selling of different types of

investment product, with the result that the level of investor protection varies depending on the nature or the legal form of the product or the status of the intermediary providing such products. The regulations do not form a homogeneous framework of rules aimed at appropriately advising and protecting retail investors with varying levels of financial literacy. This situation may be detrimental to retail investors, who are faced with increasingly complex products and associated outcomes; with variations in the information that must be disclosed to them; with difficulties in effectively comparing different products with similar features or objectives; and potential conflicts of interest within distribution channels.

1.2. Scope of substitute products

There is no legal or clearly established definition or description of the set of "substitute" investment products. It may be argued that each product offers a distinct set of characteristics and objectives and hence is not fully interchangeable with other product types. However, in the context of the blurring distinction between different investment propositions and the opening architecture of distribution, products with different legal forms may compete for retail savings and deliver the same or very similar economic objectives to retail investors. It appears that a retail investor with the **objectives of saving money on a medium- to long-term basis and maximising the potential return (interest, dividend or appreciation) through a direct or indirect exposure to a (variety of) financial market(s)** can be offered a range of broadly interchangeable products. These underlying economic criteria might underpin a working definition of "substitute" products.

The comparison of prospectuses and advertising material, and discussions with market practitioners and investors, show that, for instance, the following products may be seen as de facto alternative ways of making investments with similar economic characteristics (in terms of exposure to financial markets, investment maturity, return maximisation and so on).

- UCITS funds;
- nationally regulated retail funds;
- exchange traded or listed funds;
- most unit-linked life insurance (especially for which the mortality risk level is very small or even nil);
- retail tranches of structured notes;
- some annuities;
- some bank term deposits (e.g. with embedded optionality or derivatives or structured deposits);
- other types of product may also fall into this group...

UCITS funds, unit-linked life insurance products and structured products are discussed in greater detail in [Annex 2](#).

1.3. *What drives the promotion and sales of particular products?*

The purpose of this call for evidence is to ascertain the extent to which: i) regulation may be a factor in stimulating sales of certain products over others; and ii) sales of some products may be associated with a greater risk of investor detriment. To do this, we need to understand what factors are driving sales of different products.

Taxation

Tax is a powerful and widely used lever for Member States to influence the level of savings by individuals. Taxation regimes may materially influence investor choice between financial products and life insurance products. Savings/investment

through certain packages may attract favourable tax treatment at national level, compared to the alternatives. Traditionally, savings held in life insurance policies have benefited from more favourable tax treatment (deductibility of some contributions from income tax or exemption from capital gains tax provided the contract is held for a certain period of time). This may explain the greater success of life insurance as a savings vehicle in France, for instance.

If tax regimes are a primary or important factor in driving sales of some products, it will fall to Member States to correct the underlying distortions. Some Member States are already doing this – phasing out differences or creating tax-advantaged wrappers through which investors can invest in the full range of products, thereby avoiding inter-product distortion.

It is not the Commission's intention to focus on possible distortions created by taxation regimes, since there is limited scope for the EU to influence such developments, beyond raising awareness.

Supply-side desire to sell new products

Financial innovation has paved the way for new instruments and techniques that may deliver features attractive to investors: tax optimisation; capital protection; improved risk/return performance; tailoring to time horizons/risk profiles; flexible drawdown; etc. It is clearly a welcome development. However, new, unfamiliar products may prove challenging for investors if not properly explained or if the key risks are not communicated clearly. Costs may sometimes also be difficult to determine.

Cultural preferences

A deeply-rooted preference for local providers and nationally-branded

products may also influence investor choice. This is not necessarily an issue in itself, since EU and national rules with regard to investor protection and monitoring by national regulators will apply in any case.

Distribution business models

Within a "silo" model of product distribution, the distributor offers only products originated in-house by the parent company. This has long been seen as restricting investor choice and giving rise to possible foreclosure of markets to non-affiliated products.

Financial distribution is moving towards guided or open architectures – where distributors open the range of their products to third-party promoters, thereby expanding investor choice. This is happening at different speeds for different products. However, the open architecture model does not necessarily eliminate conflicts of interest. For instance, a distributing entity may be tempted to promote products that best suit its own interests, as opposed to those of its clients. For example, this could happen if product selection is driven by compensation arrangements with the originator. Similarly, front-line sales staff may also be inclined to recommend either the most easily understandable products or those that are on promotion at that time.

For some products and Member States, this phenomenon is mitigated by disclosure requirements on distributing compensation arrangements or fee-sharing structures. However, such requirements may differ according to the regulatory approach, and the level of disclosure required may not be comparable.

Regulatory treatment

Variations in the regulatory regimes applying to different product types might also be influential. For instance, a distributor may favour product types subject to less burdensome disclosure requirements (e.g. on fee-sharing arrangements).

This possibility emerges because regulatory approaches to investment products have long been based on institutional or product type, with the result that rules vary according to the financial market segment. As illustrated in the following table, this applies to most, if not all, elements of EU or national law in the field of financial products. That is, to rules pertaining to product constitution, to the marketing and/or the selling of such products, to investor protection and so on.

	UCITS funds	Unit-linked life insurance products	Structured notes	Bank term deposits
Product constitution	UCITS Directive	Life Directive	No rules at EU level	No rules at EU level
Capital requirement	UCITS Directive	Solvency I (to be replaced by Solvency II)	Capital Requirements Directive	Capital Requirements Directive
Independent oversight	Depositary of UCITS Directive	None at the insurance company level	No rules at EU level	No rules at EU level
Rules for disclosure to investors	Simplified Prospectus of UCITS Directive	Life Directive	Prospectus Directive	No rules at EU level
	MiFID for high-level types of disclosure requirements	Insurance Mediation Directive for some disclosure requirements	MiFID for high-level types of disclosure requirements	
	E-commerce directive or Distance Marketing Directive			
Rules for selling	MiFID	Insurance Mediation Directive	MiFID	No rules at EU level
	UCITS Directive ^{vii}			
	E-commerce directive ^{viii} or Distance Marketing Directive ^{ix}			

National frameworks - created either via the implementation of EU law or through non-harmonised national rule-making - are typically based on a similar approach. Rules are specific to the type of product and/or intermediary, rather than to an investment purpose or customer segment. This reflects the fact that these rules were designed in a context radically different from that of open architecture in distribution and the blurring distinction between products. Consequently, no single piece of legislation encompasses a set of provisions or rules that would govern, for instance, all investment propositions made to retail investors in the EU. To the extent that the provisions of these regulations are not fully consistent with one another, the choice of product type may therefore have significant implications for the regulatory burden

faced by the producer, and hence may influence producer choice.

Question 1: Do you see that different regulatory treatment of substitute products gives rise to significant problems? Please explain why you consider this to be the case.

Question 2: Do you regard the perceived concerns relating to different levels of product transparency and intermediary regulation as a significant threat to the further development of EU markets for retail investment products?

strongly agree somewhat agree no opinion somewhat disagree strongly disagree

Question 3: Is it appropriate to regard different retail investment products as substitutable - regardless of the legal form in which they are placed on the market? Which of the products listed below should be considered as substitute investment products?

- | | | |
|--|------------------------------|-----------------------------|
| - UCITS funds | <input type="checkbox"/> yes | <input type="checkbox"/> no |
| - nationally regulated retail funds | <input type="checkbox"/> yes | <input type="checkbox"/> no |
| - exchange traded or listed funds | <input type="checkbox"/> yes | <input type="checkbox"/> no |
| - unit-linked life insurance (especially which mortality risk level is small or nil) | <input type="checkbox"/> yes | <input type="checkbox"/> no |
| - retail tranches of structured notes | <input type="checkbox"/> yes | <input type="checkbox"/> no |
| - some annuities; | <input type="checkbox"/> yes | <input type="checkbox"/> no |
| - some bank term deposits (e.g. with embedded optionality or structured deposits) | <input type="checkbox"/> yes | <input type="checkbox"/> no |
| - others ... (please list and describe) | <input type="checkbox"/> yes | <input type="checkbox"/> no |

What are the features/functionalities (holding period, exposure to financial/other risk, capital protection, diversification) that lead you to regard them as interchangeable? Have you encountered any legal or other definition which would encompass the range of 'substitute investment products'?

Question 4: Which factors in your opinion drive the promotion and sales of particular investment products? Please use the table below to rank these factors in terms of importance (very significant; significant; no opinion; insignificant) for each of the different products. In addition to completing the table, we would welcome further explanation of your view as to which factors are particularly important for each product.

	UCITS	Non-harmonised funds	Unit-linked life insurance products	Retail structured products	Annuities	(Structured) Term deposits	Others
Taxation							
Financial innovation							
Cultural preferences							
Distribution models							
Regulatory treatment							
Others							

2. Is there a risk of investor detriment?

To the extent that variations in regulatory treatment may influence the relative sales of different types of investment product, the European Commission would like to investigate whether these differences translate into harmful variations in the level of transparency and investor protection.

The regulatory treatment of a particular product depends on the legal form chosen, with the result that some product types may offer lower levels of disclosure or investor protection than others. However, the exercise of discretion by product originators is not in itself problematic. Indeed, this may work to the advantage of investors. For instance, promoters could be deemed to act in the best interests of their clients when they offer investment funds or structured notes that are wrapped into unit-linked life insurance products in order to profit from tax advantages.

Competition between substitutable products is legitimate and potentially advantageous, provided that it ensures that investors are offered products on the basis of an objective assessment of their merits and appropriateness.

Ongoing discussions with stakeholders, including regulators, supervisors, industries and investor representative bodies have highlighted ways in which the regulatory context may have potentially

negative consequences for retail investors. Such concerns relate, inter alia, to product disclosures, conduct of business rules, conflicts of interest and unfair marketing.

2.1. *Different levels of product disclosure*

EU legislation governing the information that must be provided to retail investors or consumers varies by type of investment product in terms of: i) the level of information supplied; ii) its contents and usefulness to retail investors; iii) the regularity of provision; and iv) the means of accessing this information. In some cases, there are grounds to believe that investors are not receiving sufficiently clear explanations to understand the risks associated with the chosen product, or the probable ranges of investment performance that can be expected. Furthermore, they may not be fully informed about the costs of investing in different products, or about the impact of visible and hidden charges on their expected return. An example of variation in product disclosure requirements is described in Box 1.

The same type of investment proposition can be subject to different distribution rules governing the pre-contractual phase/sale recommendation, depending on the legal form. In some cases, intermediaries are required to undertake certain duties in respect of their investors, notably to know their customer and assess suitability and appropriateness.

Box 1 – Examples of variation in disclosure requirements: costs

The level of detail on costs that has to be disclosed varies considerably from one product to another. Market research suggests that investors value clear information on costs, risks and outcomes. Even institutional investors value the clear information on costs, retrocession arrangements and the other commissions that they will be charged.

UCITS: The UCITS Directive requires that entry and exit commissions and other expenses or fees - distinguishing between those to be paid by the unit-holder and those to be paid out of the unit trust's/common fund's or the investment company's assets - must be disclosed. In April 2004, the

Commission recommended that these requirements should be interpreted as disclosure of a total expense ratio (TER); the expected cost structure, i.e. an indication of all costs applicable; all entry and exit commissions and other expenses directly paid by the investor; an indication of all the other costs not included in the TER; and the portfolio turnover rate. Equally, the existence of fee-sharing agreements and soft commissions must be disclosed.

Unit-linked life insurance: The Life Insurance Directive requires publication of generic information to be provided to the policy holder. It does not provide specific disclosure requirements with regard to costs. Cost transparency in insurance wrappers is limited, e.g. no information in respect of savings, risk and cost portions is typically provided. There are no transparency requirements regarding the cost structure (TER, portfolio turnover rate, etc.) of the underlying funds. Nor are there requirements regarding annual and semi-annual reporting (portfolio composition, performance, etc) or ongoing publication of redemption prices. In particular, there is no requirement of disclosure of remuneration models in relation to charges paid by the client.

Structured products: Cost disclosure requirements within the Prospectus Directive are rather high-level and are issuer (rather than product) focussed. For instance, structured bonds, whether listed or not, are subject to less stringent disclosure requirements. They are not subject to specific disclosure as regards their cost-structure, TER, or indication of fee-sharing agreements, etc. MiFID will apply to investment services (sale advice) of structured bonds. It remains to be worked out in detail how these provisions apply to disclosure of distribution related charges (whether paid by product originator or investor) for structured products.

This raises many potential concerns over whether and how investors are provided with the necessary information to understand properly the characteristics (including on performance, costs, hidden costs, forgone performance, holding period, redemption policy, etc) of substitute investment products.

Asset managers or product originators could be required to provide 'factory-gate' information on the basic features of the investment proposition (risk/reward, costs accruing to asset manager/originator), regardless of product type. This could provide a basis for clear, transparent and broadly comparable information on the key features of different investment products.

However, there will be limits to how much comparability can be attained. For instance, the costs and charges associated with different products types take different forms and, therefore, some elements of disclosure may need to be tailored. In addition, disclosures directed to the end-investor must be kept short and

simple. This will help banks and advisors to meet their obligations accurately and to explain the approximate net return that investors can expect from these investments.

Despite these caveats, it should be possible to make progress in this direction. Ongoing work on simple cost and performance disclosures for UCITS may serve as a starting-point for comparable disclosures for other products.

2.2. *Conduct of business rules*

There are different approaches to the regulation of intermediaries who sell the majority of investment products to retail investors.

In particular, conduct of business rules vary considerably between banks, investment firms, insurance brokers or distributors. Moreover, they vary in intensity or detail for the same type of distributor depending on the form of product concerned. Notably, the requirements for distributors to test whether the product in question is suitable

for a particular customer and the "know-your-client" requirements (information that must be obtained from customers: e.g. financial situation; investment objectives; knowledge and experience; etc.) vary according to the applicable legislative framework (see Box 2).

Box 2 – Varying rules for distribution

MiFID requires intermediaries to discharge certain duties (e.g. appropriateness and suitability tests) and to give advice on financial instruments which are not sold on an "execution only" basis (i.e. products with a significant degree of complexity for investors who are neither, under the terms of MiFID, professional nor eligible counterparties). MiFID, unlike other financial services directives, includes rules on "inducements" which influence the remuneration system that is permissible for the distribution of financial instruments. The intermediary has to be impartial and to act in the best interests of the investor. However, the implementation of MiFID is ongoing and as such its harmonising effects have not yet been fully realised.

As regards unit-linked policies, the Insurance Mediation Directive provisions are not as detailed as MiFID rules. They set out high-level requirements for insurance intermediaries to deliver advice, taking into account the demands and needs of the policyholder.

The result is that the level of fiduciary care afforded to retail investors as well as the level of supervision or oversight undertaken by regulatory authorities may vary depending on the distribution channel through which they invest. Are the disciplines foreseen for the different investment products set at a sufficiently high level?

MiFID already provides a principles-based framework for ensuring a coherent approach to disclosure and point of sale regulation for all financial instruments, including all funds and structured notes. It

sets out provisions on the management/disclosure of conflicts of interest, rules on commission payments and conduct of business rules. The challenge now is to build on the high level principles of MiFID to implement coherent and rigorous point of sale disciplines for all investment products that fall within the MiFID definition of 'financial instruments' sold by investment firms, banks and advisors.

The Insurance Mediation Directive (IMD) applies to indirect sales of all insurance products by intermediaries (brokers and tied agents). The disciplines foreseen for insurance intermediaries under the IMD are seen as less stringent than those for investment firms under MiFID. Insurance mediation legislation imposes only very broad principles on the disclosure of information to policy holders or the obligations of insurance brokers towards their clients. Faced with this lack of prescription in EU law, a number of Member States have independently moved to impose rules for securities and investment products to certain insurance products. A review of the IMD is scheduled to commence in 2008. This review could be an opportune moment to undertake appropriate adjustments to this Directive, if and where needed.

2.3. Conflicts of interest

Is there a risk that some intermediaries may promote a specific product rather than another, because they are placing their own interests before those of the client - e.g. because the product is less transparent in respect of distributor remuneration or retrocession arrangements? It has been claimed that the desire to avoid disclosure of commission may lead product originators to structure investment propositions in a particular form or distributors to promote certain

types of product. The distributor duty of care may be biased by considerations regarding the regulatory burden or the liability that it bears in relation to the product it sells. Even within the same distribution channel, distributors may 'push' certain products for self-interested reasons (level of remuneration associated with one product over another, less stringent obligations on cost disclosure) and without sufficient regard for the interests of the investor.

Such unmanaged commission bias or misaligned incentives may lead intermediaries to sell products which are unlikely to be the most profitable, or most suitable, for their clients. In turn, the preferences of distributors may influence the form in which instruments are packaged by promoters. In extreme cases, regulatory "gaming" may occur, creating a situation where products are structured in order to circumvent provisions specifically dedicated to retail investor protection.

2.4. *Unfair marketing communications / misleading advertising*

Discussions with Member State authorities have highlighted concerns about the possible mis-selling of complex or risky financial products to insufficiently informed retail investors. This problem is further compounded by advertising that emphasises potential gains while concealing or understating the risk of loss. In this way, investors were led to consider structured capital-at-risk products (SCARP) in the United Kingdom, or so-called "*fonds à promesse*" in France as guaranteed investments, when in fact protection was only offered against limited market declines.^x

Some regulators have cited the possibility that misleading advertising may have

convinced retail investors to invest in products offering a capital or income guarantee at a time when such guarantees were not fully warranted. Data show that, in many Member States, sales of such guaranteed products have been high while financial markets were at a historical low.

Question 5: Product disclosures: Do pre-contractual product disclosures provide enough information to help investors understand the cost and possible outcomes of the proposed investment? Please use the attached tables to provide your evaluation of the adequacy of the information provided with regard to the following items for each category of investment product.

Nature of information provided	UCITS	Non-harmonised funds	Unit-linked life insurance products	Retail structured products	Annuities	(Structured) term deposits	Others
Product features							
Direct costs							
Indirect costs (or foregone performance)							
Risks							
Capital guarantee							
Likely performance							
Conflicts of interest							
Compensation or fee retrocession							

Question 6: Conduct of business rules: Do differences in conduct of business regulation result in tangible differences in the level of care that different types of intermediary (bank, insurance broker, investment advisor/firm) offer to their clients? For which conduct of business rules (know-your-customer, suitability, information/risk warnings) are differences the most pronounced and most likely to result in investor detriment?

	UCITS	Non-harmonised funds	Unit-linked life insurance products	Retail structured products	Annuities	(Structured) Term deposits	Others
Know your customer							
Suitability or appropriateness							
Risk warnings							
Examples - information							
Others							

Question 7: Conflicts of interest: Are there effective rules in place to ensure effective management/disclosure of conflicts of interest (and/or compensation arrangements) by the different categories of product originators and/or intermediaries for the different types of investment product? For which type of product do you see a regulatory gap in terms of the coverage of conflict of interest rules? Please explain.

Question 8: unfair marketing / misleading advertising: Is the risk of unfair marketing / misleading advertising more pronounced for some product types than for others? If so, why? Can you point to concrete examples of the mis-selling of the different types of investment product resulting from unfair marketing / misleading advertising?"

3. Is there a need for action?

3.1. *Tackling risks related to product disclosure and 'point of sale' regulation*

Pressure is growing to ensure that all financial, banking and insurance products are clearly explained, and are sold in a professional manner to retail investors. This approach assumes added importance in view of the need to create the right framework conditions to support market-driven solutions for private retirement provisioning. It would also support the successful development of financial, banking and insurance services markets in Europe.

However, this does not imply a need to address directly the divergence in rules on prudential regulation or on originating institutions. Harmonised regulatory frameworks exist which carefully reflect the balance-sheet risks and activities of the different originators. Aligning the overarching regulatory frameworks for the issuer/originator of these products or constraining their structuring or investment policies could interfere with the capacity of the market to develop innovative and investor-relevant solutions. Moreover, some safeguards that are needed for structuring and constituting funds are not necessary for, or cannot be exported to, other investment products and vice versa.

As described above, concerns have been expressed that, depending on the form of the product or the nature of the distributor, investors may not be given the right information or impartial professional support to make sound investment decisions. Some regulators note that, in their jurisdiction, the most transparent products may be losing ground to less

transparent financial products, which is undesirable.

The question is whether these risks are material and whether they warrant corrective action, for example with regard to: i) mandatory product disclosure; and/or ii) distribution regulation.

3.2. *Where should responsibility for corrective action lie?*

If a consistent approach to product disclosures and to the distribution of all investment products to retail investors is found to be necessary, what would be the most effective level for corrective action to be taken at? It should be noted that, at this stage, the European Commission has not taken a view on which level would be preferable. Contributors are invited to assess the merits of the approaches suggested below, with reference to the concerns identified above, and to suggest alternatives.

Can market forces solve the identified problems?

Product manufacturers and distributors bear a reputational risk and hence have an interest in ensuring that revenue streams are not threatened by the risks of investor detriment perceived or identified by contributors. This reasoning is supported by the fact that there are currently many industry initiatives in train to address the problem of perceived conflicts of interest in the distribution channels of some products.

The industries concerned could jointly develop self-regulation in the form of best practices or standards of product disclosures or discipline at the point of sale. This could also take the form of a code of conduct for distribution covering, inter alia, information disclosure, management of conflicts of interest, etc.

There may be a need for public authorities to encourage or co-ordinate such efforts.

However, our preliminary discussions with the industries concerned, as well as with national public authorities, investors and consumers, reveal scepticism as to the ability of market forces to remedy the situation effectively and within an acceptable timeframe.

Is there a need for public involvement?

Public authorities have already engaged with these issues. The three (CESR, CEIOPS and CEBS) level 3 committees (3L3) have discussed at joint meetings the issue of substitute products. The general opinion was that there is a need to explore this issue further.

As a starting point, the 3L3 committees could initiate a dialogue with market participants (including consumers' organisations) on this issue in order to better identify possible future steps.

Some Member States have taken initiatives in their jurisdiction. The issues of quality of disclosure and point of sale regulation may vary in nature, scope and intensity across Member States. If the issues are different in different countries, it may be more appropriate to address them at Member State level.

However, regulators may not be in a position to provide a solution at national level, since they are required to comply with EU directives. The following example is often cited as illustrative: a national regulator can impose rules of disclosure for life insurance mediation as stringent (or at a similar level) as MiFID provisions, but it cannot submit life insurance mediation to MiFID implementing provisions, should it wish to do so.

As the distribution of these products is governed by EU level legislation (namely MiFID, IMD, etc.), there is a prima facie

EU level dimension to the problem, even though the level of cross-border trade in, for instance, unit-linked life insurance products and structured notes is currently limited (see Annex 2 – [section B.3](#)). These EU rules may influence the rules of the game and the competitive interaction at national level (in most, if not all, EU countries) between investment products.

Question 9: *Is a horizontal approach to product disclosures and/or to regulation of sale and distribution appropriate and proportionate to address the problems that you have identified?*

Can you specify how this objective of coherence between different frameworks would address the problems? What are the potential drawbacks of such an approach?

Question 10: *Can market forces solve the problems that you identified (fully/partially)? Are there examples of successful self-regulatory initiatives in respect of investment disclosures or point of sale regulations? Are there any constraints to their effectiveness and/or enforceability?*

Are you aware of effective national approaches to tackle the issues identified in this call for evidence? Should it be left to national authorities to determine the best approach to tackling this problem in their jurisdiction? Is there a case for EU level involvement? Please explain.

Conclusion

The protection of retail investors is a key challenge in the context of an evolving financial services landscape in the EU. In order for the Commission to draw balanced and evidence-based conclusions on the nature and extent of any risks to investor protection arising from the variation in rules applicable to the sale of substitute investment products, the full engagement of all stakeholders - public authorities, producers and investors - is required.

At this stage, the Commission retains an open mind as to whether there is a need for action. If the evidence does warrant action of any kind, it is vital that responses are carefully targeted and proportionate to the problems identified. Failure to address genuine risks of investor detriment arising from the current situation would be a dis-service to retail investors in the EU. At the same time, ill-prepared or unfocused intervention risks imposing significant costs on producers through the upheaval of regulatory frameworks and disruption of retail distribution channels.

As the first step in this process of information gathering, we look forward to receiving your responses to this call for evidence. Contributions should be sent to markt-consult-substiprod@ec.europa.eu by 18th January 2008 at the latest.

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Annexes to the call for evidence

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Annex 1: Stakeholder perceptions of the issue

A. CONSUMER CONCERNS

In the FIN-USE^{xi} reply to the Commission consultation on the Green Paper on the enhancement of the EU framework for investment funds, consumer representatives explained that the lack of consistent standards of investor protection throughout the different investment options available to them is a result of the 'silo' approach the Commission follows. They cite the example of costs, where it seems to them that commissions are bigger and less transparent in insurance-based products. They stress also that the MIFID provisions on inducements on sales commissions do not apply to these products as well. As regards structured products which are regulated under the Prospectus Directive, consumers note that their time-to-market is significantly faster, and the process simpler, than for UCITS products. FIN-USE concludes that this *"is unhealthy for consumers and providers if competing mass market retail products are not regulated in a coherent and proportionate way"*.

B. PUBLIC AUTHORITY CONCERNS

B.1. At EU level

The issue of competing products has attracted considerable attention from the policy-making community at EU level.

In June 2007, Member of the **European Parliament** Ieke van den Burg called *"for disclosure of value chain costs to the clients in order to introduce more transparency and ensure a level playing field for competition"* in her report.^{xii} The issue also features in the own initiative DRAFT report on asset management^{xiii} which *"[...] requests, in this context, a review of the legislative framework on the marketing, advice and sale of all retail investment products by the end of 2008 at the latest, [...]"*.

In May 2007, the 27 Finance Ministers (meeting in the ECOFIN **Council**) formally invited the Commission to review the consistency of EU legislation regarding the different types of retail investment products (such as unit-linked life insurance, investment funds, certain structured notes and certificates). The 27 Finance Ministers expressed concerns about potential *"mis-selling"*. At European **Commission** level, Commissioner McCreevy echoed^{xiv} these concerns about the regulatory patchwork governing the marketing and sale of different types of investment products or market-based mechanisms for asset-gathering and (long-term) savings.

Notwithstanding differences in the respective remits of supervisors under national legislation, the three European committees of securities (**CESR**), banking (**CEBS**) and insurance (**CEIOPS**) supervisors have also begun to jointly examine the issue. The conclusions of a brainstorming session in June 2007 are illustrative: *"A vivid discussion took place regarding the issue of substitute products. It became clear that relatively many members [i.e. securities, banking or insurance regulators of the 27 Member States] do face challenges regarding the un-level playing field from the point of view of the competition and investor protection. Some have developed a national solution. The general opinion was that there is a need to explore this issue further"*.

B.2. At Member State level

In its May 2007 analysis^{xv} of structured products, the **Netherlands** Authority for the Financial Markets (AFM) stressed its concerns that investors in structured products do not always understand the way in which such products work and consequently may select an unsuitable product. In addition, the AFM finds that *"the information provided to investors is not as it should be. Prospectuses do not focus sufficiently on the information that consumers need to make well-considered investment decisions. In addition, the legal entity chosen for the products means that financial information leaflets are not obligatory. This makes brochures the consumer's principal source of information. Brochures vary considerably in quality"*.

In an article^{xvi} in its Monetary Review, the **Danish** Central Bank found that *"the exact characteristics and costs of the [structured] products are difficult to assess for the individual investor"*. [...] *This makes it hard to distinguish the lotto coupons from the sound investments. Calculations [...] show that the parties behind the index-linked bonds have historically made a good profit from the sale of these bonds. Investors, on the other hand, have incurred a risk that is higher than on investment in e.g. government bonds, without being rewarded with higher average returns"*. The article cites a clear lack of transparency about the cost structure of such products.

In its response to consultation on the proposals for modification of the UCITS directive, the **French** *Autorité des marchés financiers* (AMF) confirms that, in its view, significant competitive anomalies exist in relation to products that are otherwise economically comparable. The AMF states that the priority is to ensure that investor information conditions are comparable. However, the AMF notes that structured bond products or certificates may be marketed in France on the basis of a pre-contract document (the prospectus summary) whose contents are not as detailed as those of the current simplified prospectus for investment funds. Already in 2005, Mr. Jacques Delmas-Marsalet cited^{xvii} the example of *"a French producer whose complex and high-risk investment products packaged as a UCITS fund, subject to marketing restrictions by the AMF, was able to avoid oversight by the regulator by adopting another legal form and repackaging it as an identical structured product involving the same degree of risk and complexity within the framework of a unit-linked insurance product issued and listed by its subsidiary in another Member State"*. The report explained further that a *"cause of the unequal playing field between products are differing conditions for the oversight and control over marketing documents for "financial products" and "insurance products."* In effect, while the AMF [the French Securities regulator] can exercise pre-publication control over all marketing documents for financial products falling under the scope of its authority, this is not the case for the ACAM, the French insurance regulator. [...] *In addition, while investment service providers are subject to the obligation to issue risk warnings for complex products purchased directly, this same obligation does not apply to insurers for such products included in unit-linked policies if not excluded by regulation"*.

C. INDUSTRY CONCERNS

The investment fund industry has drawn the attention of the European institutions to the need for the creation of a level playing field for the various retail investment products and to make the regulatory framework more consistent at the point of sale and at production level. In the 2006-2007 annual report^{xviii}, EFAMA (European Fund and Asset Management Association) Chairman states that *"In the past few years the number of competing products has increased steadily and with growing speed. This is not bad per se, but problems will arise if those products are not only less regulated and supervised than funds, but also less transparent and*

providing a lower level of investor protection. They are often not fully understood by the normal retail investor to whom they are offered with the same purpose as funds."

The insurance industry also encourages *"the Commission to launch an evaluation of existing information requirements in the insurance field"*. In this context, the European Insurance and Reinsurance Federation (CEA) welcomes both the Commission workshop on retail financial services in November 2007 and the cross-sector study to follow in 2008 on the appropriateness and consistency of information requirements in financial services. CEA adds that *"the provision of high-quality rather than – in terms of quantity – excessive consumer information is fundamental to enable markets to function, and is the basic principle of consumer protection. However, the information requirements imposed on insurers by different EU legal acts do not fulfil this condition, so that ultimately this may create difficulties both for the consumer and the supplier"*^{xix}.

On the side of structured product promoters, a major industry player states^{xx} that *"regulations governing the retail SIPs [structured investment products] market are fragmented and localized. There are no common objectives between regulators in the various countries and efforts made so far have not had the desired result"*. It advocates simplification of the rules and convergence between regulatory approaches to improve market transparency.

Annex 2: Comparison of functionalities, market size, distribution channels and legal framework for selected retail investment products

This annex contains detailed description of the characteristics of three types of retail investment products: **i) investment funds; ii) unit-linked life insurance products; and iii) structured notes**. These 3 case studies are illustrative and are not intended to constitute an exhaustive list of substitute investment products.

A. FUNCTIONAL DESCRIPTION

A.1. Economic description

Investment funds are a form of collective investment vehicle that invests (purchases assets, such as stocks, bonds and money market, etc.) the pooled funds of a large number of investors for a fee. Funds raise money by selling shares of the fund to the public/investors (like any other company which can sell stock to the public). In return, shareholders receive an equity position in the fund.

Unit-linked life insurance products, apart from offering biometrical risk coverage, can serve as savings products offered by insurance companies. The investment is made under a contract between the insurer and the investor, under which the insurer invests the money on the investor's behalf. The assets are owned by the insurance company, which promises to provide a return to the customer based on the investment performance of the underlying assets. In exchange for the amount invested, the investor is provided with a contractual right to a share in the income, profits or losses from a defined asset pool. The insurer may manage (internally) the assets on which the units are based, or use the money provided by the investor to buy units in a fund, or funds managed by third parties.

Structured products/notes are securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency. In simpler terms, a structured product is essentially a contract between the investor and the issuer, usually an investment bank which promises to make at a certain time a payout based on a formula explained in the prospectus.

A.2. Customer segment

Each of these financial industry sectors comprises a well developed retail segment in the EU.

Investment funds may be UCITS or nationally regulated funds. UCITS are designed for retail investors although around 25% of assets under management (AuMs) are distributed to institutional investors. They are increasingly distributed on a pan-European basis through the UCITS "passport". Nationally regulated funds may be authorised, provided certain national rules are met, for distribution to retail investors.

According to the life insurance industry, the vast majority of, if not all, **unit-linked life insurance products** are contracts with mass and affluent market policyholders, including high-net worth individuals (HNWIs).

Although **structured notes** may be specifically designed to meet institutional investors' needs, market research suggests that in the EU the vast majority of structured notes issues are held by private individuals.

A.3. Economic objectives

Investment funds, notably UCITS intend: 1) to yield a superior return than a traditional bank deposit by investing in specific investments (in line with the objectives of the investors and the regulatory constraints); 2) to give investors access to a wider range of securities than the investors themselves would have been able to access (diversification); 3) to assure redemption on demand (liquidity) and 4) to reduce trading costs by gaining economies of scale in operations.

The purposes for which **unit-linked life insurance products** are purchased vary widely from retirement savings to tax-advantageous short-term investments. Depending on the investment objective, the importance of the insurance element can also vary. They are predominantly used for regular premium pension saving. Non-pension medium-term savings are mainly lump sums.

Structured products intend: 1) to yield superior returns than traditional bank deposits; 2) to give investors access to complex investment strategies and a wider range of securities and asset classes that would not usually be available through traditional investment funds, for example, a specific basket of equities, commodities, foreign-exchange and hedge funds; 3) to assure a certain level of liquidity (although redemption is discouraged by penalty exit-fees in some cases); and 4) to lower trading costs via economies of scale. Combinations of derivatives and financial instruments create structures that have significant risk/return and/or cost savings profiles that may not be otherwise achievable in the marketplace. Structured products are designed to provide investors with highly targeted investments tied to their specific risk profiles, return requirements and market expectations. Some structured products offer full protection of the principal invested, whereas others offer limited or no protection of the principal. In other cases, losses can be magnified by leverage.

A.4. Investment features and restrictions

To protect retail investors, in addition to rules relating to fund diversification, liquidity and use of leverage, the **UCITS Directive** imposes strict rules on the investment policy of funds. The discretion of the fund manager is legally restricted so that investors do not have to rely on the skills and the due diligence of the fund manager alone. Under these rules, only transferable securities (mainly equity and bonds) were eligible assets. Directive 2001/108/EC has expanded this list to include also money market instruments, units of UCITS and other collective investment undertakings as well as banking deposits and allows greater use of derivatives, although under strict conditions. Non-UCITS which are authorised for retail distribution at Member State level have to comply with similar rules, albeit some variations notably in terms of eligible assets or diversification limits.

Unit-linked life insurance products can invest in UCITS as well as in non-UCITS like real estate funds. They also allow funds within a fund. There are no limits on liquidity.

Structured products are more complex in terms of investment strategies. They are generally not bound by any restrictions specifying the permissible level of market risk. As a result, the

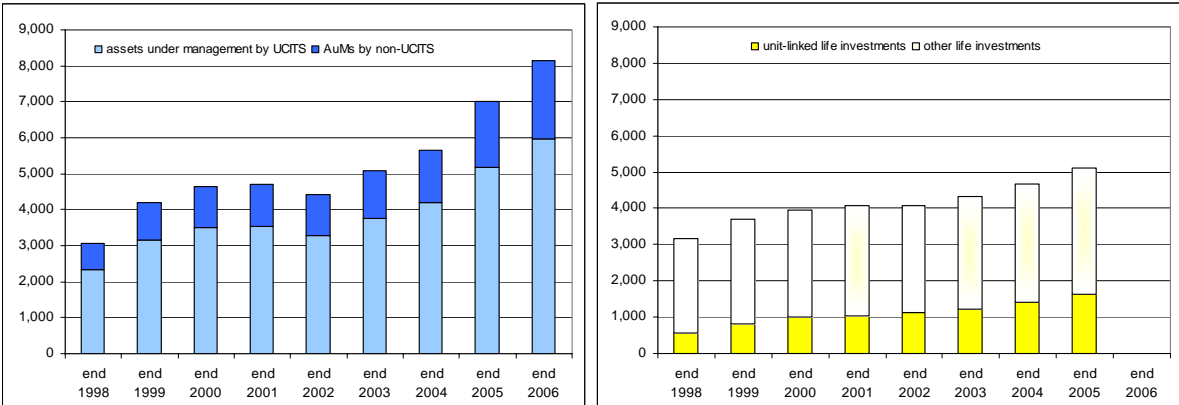
range of assets has expanded considerably over recent years (equities, investible indices – including commodity, hedge fund or forex indices – or even house price movements). The underlying assets are not the single parameter to take into account to assess structured product features. The others are: exercise ratio (the fraction of the underlying invested in derivatives), maturity (the point in time when the structured product is redeemed) and the pay-out terms.

B. MARKET SIZE

Sources of data and figures in the two sections below: Association of British Insurers (ABI); Bank of England (Financial stability review); European insurance and reinsurance federation (CEA); Deutsche Bank research; FERI Fund Market Information; European Fund and Asset Management Association (EFAMA); International Swaps and Derivatives Association (ISDA); Netherlands authority for the Financial Markets (NL-AFM); PricewaterhouseCoopers; Société Générale Corporate & Investment Banking (SGCIB); Structured Products Association; Swiss Re sigma research; www.structuredretailproducts.com; and European commission estimates.

B.1. Size of outstanding capital – comparison of scale

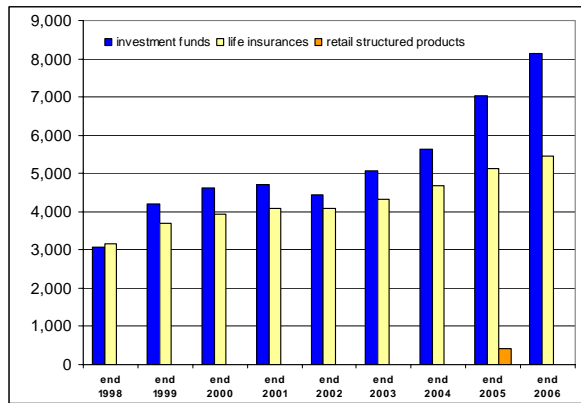
At end of Q1 2007, assets under management by UCITS amounted to € 6,213 billion; EU non-harmonised investment funds, € 1,666 billion plus c.a. € 350 billion by EU managed hedge funds and € 180 billion by private equity funds.



In € billion

The total investments of the life insurance industry were estimated at € 5,460.30 billion at end of 2006, up from € 5,127.00 billion in 2005 out of which 32% are related to unit-linked products.

At the end of 2005, the total outstanding capital invested in structured products by retail investors was estimated to be at least € 423 billion. No other data are readily available in terms of outstanding capital for other years.

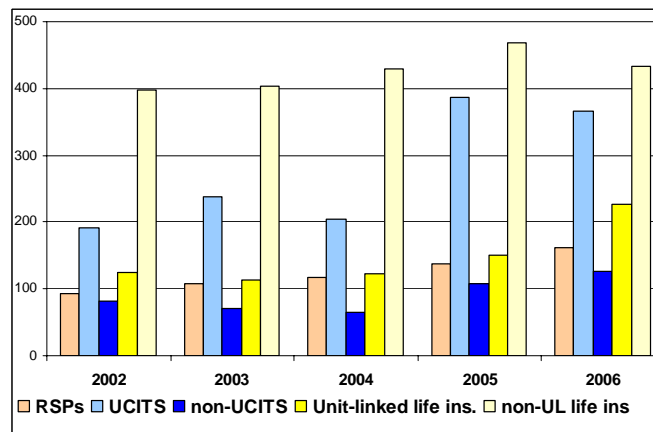


In € billion

Despite the lack of data on outstanding capital of retail structured products in the EU, a comparison of scale suggests that this market remains relatively small in comparison with the markets for UCITS and retail non-UCITS, and also for unit-linked life insurance products.

B.2. Net sales in EU and certain Member States

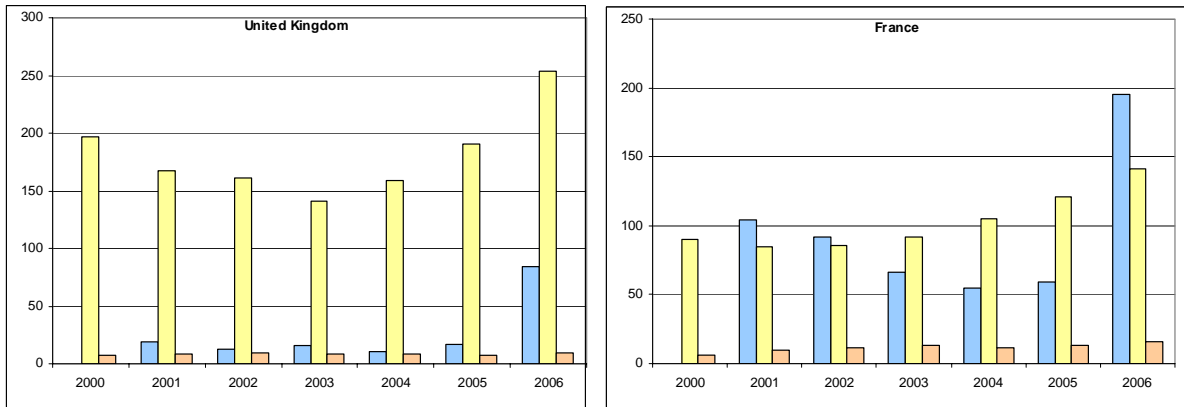
In terms of EU sales, however, retail structured products are performing very well, just behind unit-linked life insurance products but above non-UCITS. Non-unit-linked life insurance products and UCITS remain the best performers in terms of sales in EU.



In € billion

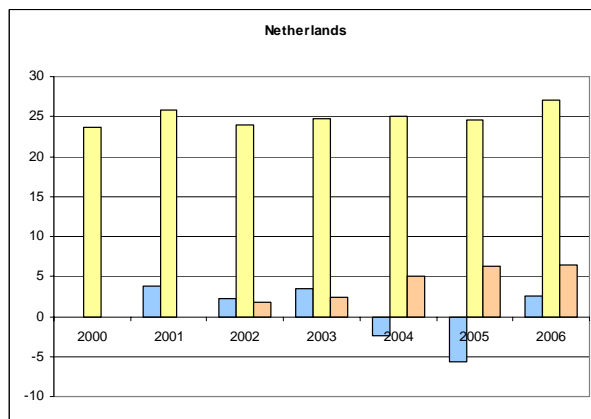
Interestingly, four patterns are emerging at national market level. In the following diagrams, premia to life insurance products are in yellow; net sales (inflows less outflows) of funds in blue; and sales of retail tranches of structured products in orange.

- UK and France remain markets for funds and life insurance products. Structured products are less developed:



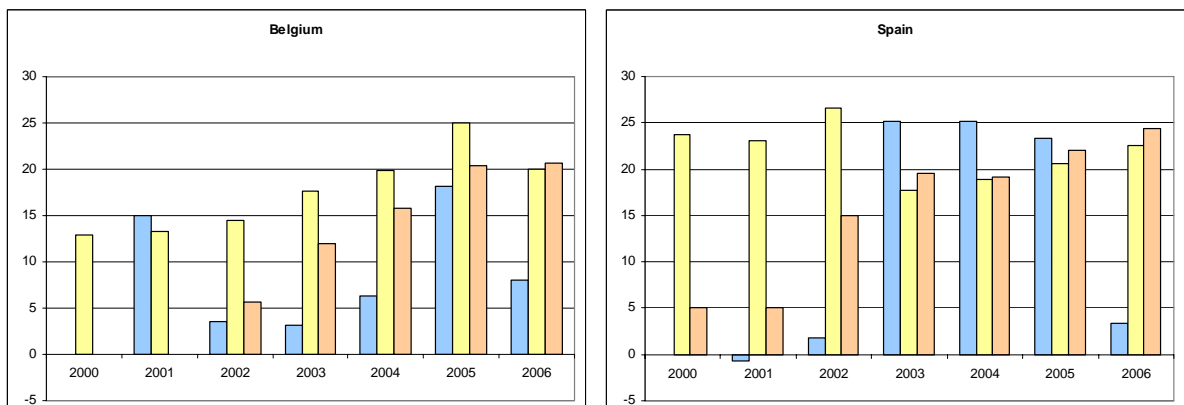
In € billion

- In the Netherlands, where fund sales are historically low, structured products are increasingly competing with life insurance products:



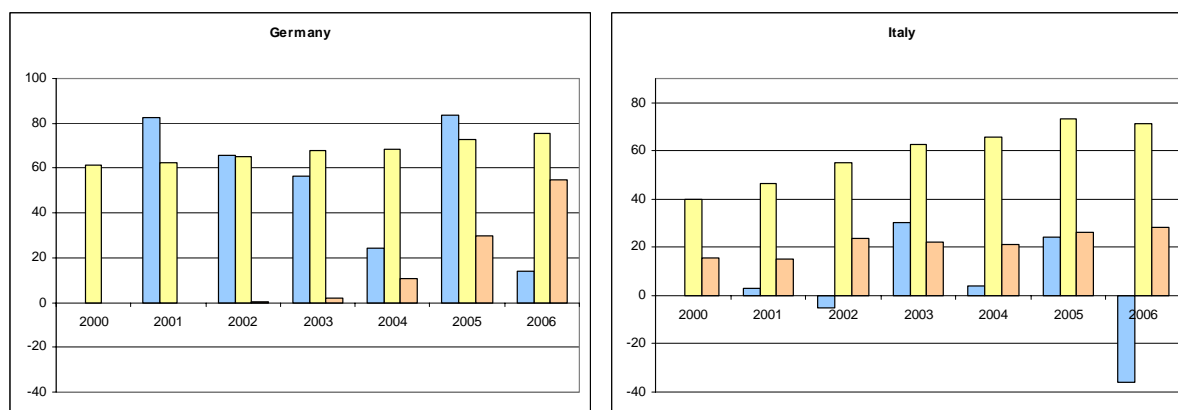
In € billion

- In Belgium and Spain, structured products are competing with other forms of savings;



In € billion

4. In Germany and Italy, structured products are gaining market share over other products, notably funds:



In € billion

B.3. Cross-border sales

UCITS are increasingly sold on a cross-border basis in the EU, with Luxembourg and Ireland as leaders. This is widely explained by the UCITS Directive and the pan-EU passport that it provides to investment funds complying with its provisions.

Life insurance products are distributed on a cross-border basis much less frequently. However, market data suggests that in 2005, Luxembourg, Ireland and UK based life insurance products (not only unit-linked products) have received premia from Member States other than the jurisdiction of domicile (respectively, 90.61%; 36.48%; 9.63% of the total premia). Contract law and claims settlement as well as taxation systems represent a more significant barrier to the cross-border sale of unit-linked life insurance.

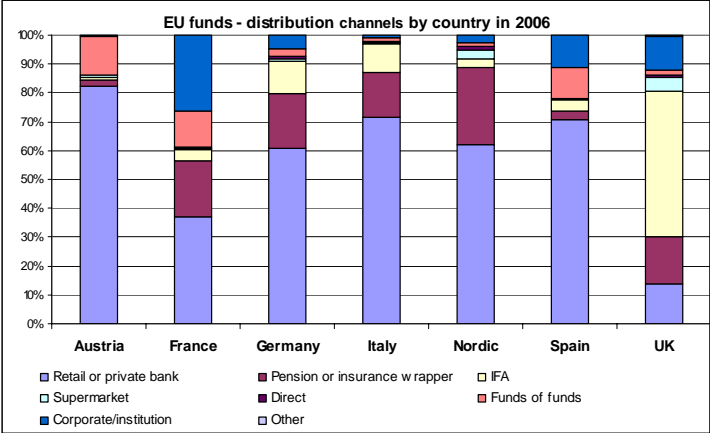
Although no data is readily available, it seems that cross-border sales of structured products are negligible in the EU. This appears at odds with the Prospectus Directive provisions allowing the pan-EU distribution of notes which comply with its requirements. It may be due to a cultural preference for nationally branded products. The cross-border sale of structured notes/funds could easily develop – the current low levels of cross-border sales reflect commercial or cultural factors and the geographical organisation of distribution systems: there are no major regulatory or legal impediments to their cross-border offer.

C. DISTRIBUTION CHANNELS

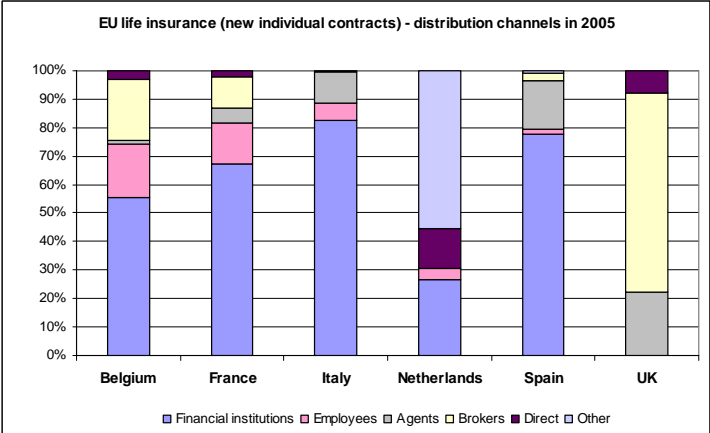
Sales of investment funds, unit-linked life insurance products and retail tranches of structured products take place through similar distribution channels.

In the EU, commercial banks and insurance companies remain the largest distributors but their market share in fund distribution fell from 97% to 75% between 1990 and 2005. In the UK, independent financial advisors (IFAs) are the main distribution channel. The distribution of funds is evolving towards open architecture (i.e. opening up the existing distribution channels to third-party funds) or 'guided' architecture (where distributors select a limited number of additional providers to increase and/or change the range of products they sell through their distribution network). The market share of these business models is reported to have increased from 2% to 11% between 1990 and 2005. Moreover, new

distribution channels emerge, such as IFAs – the share of IFAs increased from 1% to 7% between 1990 and 2005 - as well as Internet-based distribution channels. However, this process is slow and varies significantly by jurisdiction.



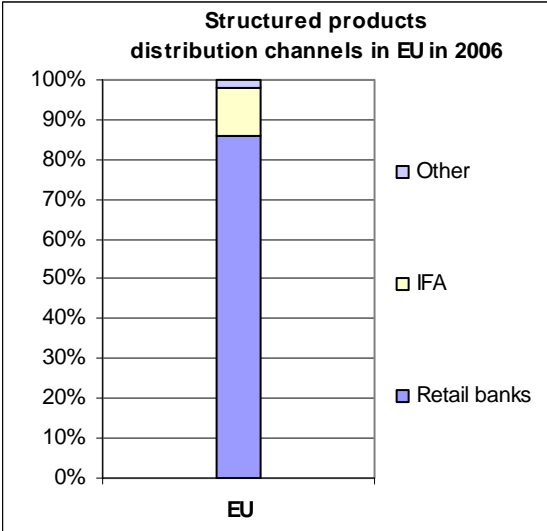
No readily available data has been found on distribution channels for unit-linked life insurance products. Thus, this graph encompasses all life insurance products (not only unit-linked ones) in the concerned countries. They are premiums to new individual contracts. Financial institutions (i.e. banks) remain the main distribution channels, except in the UK where brokers predominate. Life insurance distribution is also taking place through employees (of the insurance company) and agents, which all are insurance networks. Anecdotal evidence suggests that unit-linked life products tend to be sold through an advised sale. Distribution methods vary considerably across the EU.



Banks are the primary distributors of structured products in the retail market, with a market share close to 86%. The main reason for this is that small retail investors - the bulk of the market in most countries - prefer to buy these products through banks. Some banks choose only to market their own products, while others sell structured products manufactured in-house plus those structured by other organizations (known as open-architecture framework). IFAs and brokers accounted for 12% of structured product retail sales in 2005. They are individuals or organizations employed to provide investment advice on a fee basis, with brokers acting as intermediary between the product issuers and buyers of structured products. They can either sell structured products from multiple issuers or from one single issuer. There are also other distributors, such as insurance companies in Germany and Belgium, post offices and even supermarkets in the UK, and online platforms in Italy and Switzerland.

Data on distribution channels are not readily available as regards structured products. However, industry estimates distinguish between three types of clientele:

- Retail customers: commercial banks are the key distribution channel for this segment (estimate: 85%). IFAs are the second channel.
- HNWI: Private banks and IFAs are a particularly important means of distribution across Europe, except in Germany and Italy.
- Institutional investors: direct distribution (from the structurer) is the most popular option for institutional investors.



Cross-product interaction: Due to the lack of readily available data on the composition of structured products portfolios, it is not possible to know to what extent they may encompass investment funds. However, anecdotal evidence suggests that they are emerging as a distribution channel for investment funds. Finally, anecdotal evidence suggests also that life insurance wrappers are increasingly used to wrap retail structured products. With the exception of Austria and Spain, insurance or pension wrappers are emerging as the second way of distribution of investment funds.

D. LEGAL AND REGULATORY TREATMENT UNDER EU LAW

D.1. Legal approaches

In all Member States, **investment funds** or units in undertakings for collective investments are addressed by national law, which distinguishes them from other financial products or assets.

They belong therefore to a *sui generis* category. At EU level, the UCITS Directive defines UCITS as undertakings the sole object of which is the collective investment in transferable securities and/or in other liquid financial assets referred to in Article 19(1) of capital raised from the public and which operates on the principle of risk-spreading and the units of which are, at the request of holders, re-purchased or redeemed, directly or indirectly, out of those undertakings' assets.

A **unit-linked life insurance** is a product offered by insurance companies. The investment is made under a contract between the insurer and the investor, under which the insurer owns

the underlying assets on which any investment return is based. In exchange for the amount invested, the investor is provided with a contractual right to a share in the income, profits or losses from a defined asset pool. The insurer may manage the assets on which the units are based, or use the money provided by the investor to buy units in a given fund, or funds managed by third parties. There is no legal definition of unit-linked life insurance products within EU law. Annex III "Information for policy holders" of the Life Insurance Directive^{xxi} indirectly describes unit-linked policies (see items (a)11 and (a)12) by requiring specific information for policy holders of such products.

Structured products may adopt different legal forms according to the market they target, the distribution channels they use or the jurisdiction where they are domiciled. Most EU-based structured products adopt the legal form of a bond or a note, e.g. in Germany most structured products or certificates are bonds for legal and tax efficiency reasons. In France for instance, they may take the form of an investments fund, i.e. structured funds or "formula" funds where the assets in which the fund invests combine some secure investments with derivatives. But some French structured products are also bonds. Finally, in some countries, such as Belgium, structured products adopt the legal form of a life insurance contract.

D.2. Description of EU regulatory framework

D.2.1. Rules for product constitution

Under the **UCITS Directive**, UCITS must comply with investment restrictions (eligible assets, risk dispersion, diversification, etc.). They must be redeemable on investor demand. And, they must comply with rules to protect investors such as: initial approval of the management company, fund rules, choice of depositary, capital requirement, risk management process, etc. Each new UCITS has to be authorised by the competent authority, i.e. authorization is given product by product. Any change to the management company or the depositary must be approved by the home regulator.

Unit-linked life products are regulated by the **Life Insurance** and **Solvency 1** (to be amended as Solvency II) Directives and the Capital Requirements Directive (CRD). Thus, specific solvency and prudential rules apply to the originators of unit-linked life insurance products. The life company's capital has to fulfil the requirements of the CRD. Authorisation is given to the insurance company for a whole insurance class. Once a company has been authorized in the class of insurance devoted to unit-linked insurance, it is allowed to sell, without prior approval, new contracts that falls within one of the categories listed in the authorisation.

There is no EU piece of legislation which governs the constitution of structured products with the legal form of a bond. Structured products with the legal form of investment funds or life insurance products are subject to the relevant EU rules governing the constitution of such products. Each prospectus has to be authorised by national authority. The Prospectus Directive allows incorporation of a prospectus by reference to previously published documents that have been approved.

D.2.2. Rules for disclosure to investors

UCITS are subject to disclosure requirements as set out in the **UCITS Directive** in the form of the **Simplified Prospectus** that must be provided before the conclusion of the contract

and, on request, a full prospectus, an annual report and a half-yearly report covering the first six months of the financial year. In addition, **MiFID** imposes high-level disclosure requirements notably in relation to the distributor (when it is MiFID regulated).

The third Life Insurance Directive of 1992, consolidated by the 2002 Directive concerning (the **Consolidated Life Directive**) direct life insurance, indicates in a detailed list the information to be provided to the policyholder prior to the conclusion of the contract. The information will first relate to the insurance undertaking and to the commitment itself. Specifically regarding unit-linked policies, definition of the units to which the benefits are linked as well as indication of the nature of the underlying assets must be disclosed. The **Insurance Mediation Directive** (IMD) includes some disclosure requirements regarding the intermediary (status, service and suitability).

Structured products (with the legal form of bonds) which are intended to be distributed to the public on a pan-EU basis are subject to the **Prospectus Directive**. Prospectuses must describe the essential features and risks associated with the issuer and the securities issued. The information required includes considerable detail on the issuer, but may be less explicit about the financial details of the product. In addition, **MiFID** imposes high-level disclosure requirements notably in relation to the distributor (when it is MiFID regulated).

D.2.3. Rules for product distribution

Direct sales by the management company of its own products are governed by the relevant provisions of the **UCITS Directive**. **MiFID** applies to intermediaries which sell third-party investment funds. It provides rules on conduct of business, management of conflicts of interest and quality of order execution as well some disclosure (related to the distributor) provisions.

The **Insurance Mediation Directive** requires insurance intermediaries to deliver written advice, taking into account the demands and needs of the policyholder. The scope of this obligation might be considered to be similar to that applying to financial advisors. However, employees of insurance companies, who are not considered as intermediaries, are not within the scope of IMD and hence are not subject to the same obligation.

MiFID applies to distributors which offer either third-party or proprietary structured products with the legal form of a bond. **MiFID** provides rules on conduct of business, management of conflicts of interest and quality of order execution as well some disclosure (related to the distributor) provisions.

D.2.4. Other potentially applicable EU rules

In addition, other provisions of EU law may be applicable to the distribution of investment products.

According to the **E-Commerce Directive** service providers are entitled to provide their services by the means of Internet throughout the EU, exclusively on the basis of the rules of the Home Member State without any further restriction. Indeed, in contrast to the UCITS Directive, for instance, which confers some residual competences to the Host Member State, the e-commerce Directive is based on a strict "country-of-origin" principle. This Directive imposes certain information requirements for the conclusion of contracts by electronic

means. In addition to other information requirements established by EU law, the service provider must give the following information prior to the service provision:

- the technical steps to follow to conclude the contract;
- whether or not the concluded contract will be filed by the service provider and whether it will be accessible;
- the technical means for identifying and correcting input errors prior to the placing of the order;
- the languages offered for the conclusion of the contract;
- any relevant codes of conduct to which he subscribes and information on how those codes can be consulted electronically;
- contract terms and general conditions provided to the recipient must be made available in a way that allows him to store and reproduce them.

Moreover, the service provider shall render information on its name; address; e-mail address; company registration number; professional title; VAT number; and details of membership of professional associations easily, directly and permanently accessible. These requirements are in addition to those imposed by MiFID.

The **Distance Marketing Directive** (DMD) applies to distance sales, inter alia, to the distribution of financial services or products sold by the means of distance communication, i.e. those means which do not require the simultaneous physical presence of the supplier and the consumers such as fax, telephone and again Internet. In contrast to the e-commerce Directive and similarly to the UCITS Directive the Distance Marketing Directive recognises certain residual competences of the Host Member State. The Distance Marketing Directive also regulates the information which has to be provided to the investor. The "distance marketing information" must be provided before the client is bound by a contract. This information includes:

- all the contractual terms and conditions and the information on paper or on another durable medium available and accessible to the consumer in good time before the consumer is bound by any distance contract or offer;
- the identification of the supplier;
- the description of the financial services;
- the characteristic of the distance contract; and
- the existence of a redress.

Although the DMD requirements appear to add a separate layer of information to be disclosed, these requirements are often already satisfied through existing disclosure requirements. They are partly similar to those of the UCITS Directive.

These two Directives may be seen as making the regulatory patchwork governing distribution of financial products to retail investors even more complex. The question of the relationship of their provisions with those of other Directives (such as MiFID, UCITS, IMD, Prospectus, etc.) may arise. The two directives do not establish exemptions to the application of the complementary provisions of the UCITS, MiFID, Life Insurance and Insurance Mediation Directives. The obligations to offer information and advice provided for by these latter directives should consequently be applicable for distance marketing.

Other concerns arise when investors purchase financial products directly from the issuer/promoter, via the Internet, for example, without the services – and, so, without, the advice - of an adviser or a distributor. In so doing, they make an investment decision on an "execution only" basis - they can then only rely on their own examination of the prospectus and the brochure - as the transaction takes place at the client's initiative.

D.3. Different national approaches at Member State level

D.3.1. Product constitution

Nationally regulated investment funds offered to retail investors are subject to similar rules to those applicable to UCITS in most, if not all, Member States. All Member States have put in place rules such as approval of the management company and its instruments of incorporation, the fund rules and the choice of a depositary; authorisation of funds by the competent authority; sufficient good repute and sufficient experience of the directors of the management company and the depositary. In order to protect investors, notably retail ones, Member States generally set out an exhaustive list of eligible assets although these may be different from the UCITS Directive list (e.g. real estate, commodities, etc.); fixed quantitative investment limits (issuer concentration limits, counterparty risk, limit to market risk); exclusions or restriction of certain investment techniques (e.g. no short sales, no borrowing); etc.

Unit-linked life insurance products: National regimes for the constitution of unit-linked life insurance products are based on or implemented from the EU legislative framework (Consolidated Life Insurance Directive). However, this minimal harmonisation framework does not result in large scale pan-European distribution of unit-linked life policies, due to differences in Member States' contract law, tax requirements and pension arrangements.

Constitution (or incorporation) of **structured products with the legal form** of bonds is regulated at national level. Depending on the Member State in which it is based, a structured note issuer will have to comply with the relevant provisions of company law or contract law.

D.3.2. Product distribution and disclosure to investors

The MiFID includes a number of harmonised rules and requirements related to provision of certain financial services, investment advice and disclosure of appropriate information. As mentioned above, those rules are applicable to intermediaries offering third-party investment funds (a management company directly distributing its self-issued funds is not subject to MiFID) or structured notes. MiFID implementation is expected to provide for harmonisation of these rules.

The Life Insurance Directive allows Member States to require insurance undertakings to furnish additional information "*if it is necessary for a proper understanding by the policy-holder of the essential elements of the commitment*". Sales of unit-linked life insurance products are regulated by the Insurance Mediation Directive. However, the IMD is a minimum harmonisation Directive, and national regimes for sales of unit-linked life products are often more prescriptive than the IMD.

End notes:

- ⁱ See Council [Conclusions on Commission White Paper on enhancing the Single Market Framework for Investment Funds](#); 2798th ECONOMIC and FINANCIAL AFFAIRS Council meeting, Brussels 8 May 2007.
- ⁱⁱ See the Bank for International Settlements [report](#) on International Developments in Banking Supervision, September 2006, page 5. see also the subgroup on "[customer suitability](#)" established by the Joint Forum.
- ⁱⁱⁱ See Wolf Klinz, 17 July 2007, [DRAFT report](#) on Asset Management II; Committee on Economic and Monetary Affairs.
- ^{iv} See, for instance, [Responses](#) from FIN-USE to Initial orientations of possible adjustments to UCITS Directive.
- ^v See BEUC [response](#) to the Green paper on retail financial services
- ^{vi} See, for instance, ZEW/OEE report "[Current Trends in the European Asset Management Industry](#)" stating that "*Distribution dynamics are shifting dramatically, as vertical integration diminishes and [...] distributors [...] have opened their architecture*".
- ^{vii} UCITS Directive applies to sales of own (in-house originated) products by a management company. Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) ([85/611/EEC](#))
- ^{viii} The E-commerce Directive applies to cases where the conclusion of the intermediation contract takes place through any electronic means.
- ^{ix} The Distance Marketing Directive (DMD) will apply to distance sales, inter alia, to the distribution of financial services or products sold by the means of distance communication, i.e. those means which do not require the simultaneous physical presence of the supplier and the consumers such as fax, telephone and again Internet.
- ^x Source: report on the [marketing of financial products](#), presented by Jacques Delmas-Marsalet to French Minister of the Economy, Finance and Industry, in November 2005
- ^{xi} The FIN-USE [forum](#) is an independent panel of experts including consumer protection and small business experts, academic researchers and staff from major consumer and small business organisations.
- ^{xii} Committee on Economic and Monetary Affairs, Own-initiative report procedure: Report on financial services policy (2005-2010) - White Paper PE 384.621v03-00 [A6-0248/2007](#); 28 June 2007
- ^{xiii} See Wolf Klinz 17 July 2007 [DRAFT report](#) on Asset Management II; Committee on Economic and Monetary Affairs
- ^{xiv} See 8 May 2007 [Commission statement](#) on White Paper on Asset Management.
- ^{xv} Netherlands Authority for the Financial Markets, [Exploratory analysis of structured products](#); May 2007
- ^{xvi} Danmarks Nationalbank; [Monetary Review](#) 2nd Quarter 2007: Index-Linked Bonds, Anne-Sofie Reng Rasmussen, Market Operations (page 51).
- ^{xvii} Report on the [marketing of financial products](#), presented by Jacques Delmas-Marsalet to French Minister of the Economy, Finance and Industry, in November 2005
- ^{xviii} EFAMA [annual report](#) 2006-2007
- ^{xix} See CEA [position paper](#) on the Green Paper on Retail Financial Services COM(2007) 226 final; 16 July 2007
- ^{xx} See Société Générale Corporate & Investment Banking; The [European Retail Structured Investment Products Market 2006](#), published in December 2006
- ^{xxi} Directive [2002/83/EC](#) of the European Parliament and of the Council of 5 November 2002 concerning life assurance