Finance Watch
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PRODUCT RULES FOR PACKAGED RETAIL PRODUCTS: WHY, WHEN, HOW?

Discussion paper in the context of the PRIPs regulation proposal

Summary and key points

1. The large number of financial product mis-selling cases in EU Member States is evidence that intervening at the point of sale is not always sufficient, and that it is preferable for all stakeholders to ***intervene earlier and prevent consumer detriment before it occurs*** rather than after.

2. As a significant portion of mis-selling cases is related to product failure, this requires in our view ***action targeted at this specific issue*** such as product design rules, within product governance.

3. The success of UCITS is evidence that a ***sound framework is valued by retail investors*** and that product investment rules do not have an adverse impact on choice and innovation.

4. Existing Member States product rules ***share a common purpose, and their tried and tested principles have significant overlaps***. This should facilitate agreeing on a set of common principles without delaying the PRIPs file.

5. Based on existing product regulations, we propose a ***set of six principles***. Such principles could be used either for banning detrimental features alternatively for a warning label on the KID. We believe that these principles would have prevented many of the recent mis-selling cases.

6. Based on the evidence from UCITS, such rules are expected to significantly strengthen investor protection with a ***neutral or positive impact on the industry***. Such rules should contribute positively to reducing redress costs and reputational costs for manufacturers, and would have a positive impact on restoring investor confidence and engagement with financial markets.

7. Since such rules are not related to advice but to product design, and also in order to be consistent with UCITS, we are convinced that ***PRIPs is the place to introduce them***. UCITS includes indeed not only a KIID but also product investment rules. These rules are complementary to MiFID product intervention supervisory measures, and product design rules within PRIPs should similarly be a useful complement to MiFID product intervention measures.

8. We believe that ***PRIPs is an opportunity not to be missed to get it right with investor protection*** and to meaningfully address mis-selling issues.

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INTRODUCTION

We provide this background paper on product rules in the context of the Council and Parliament negotiations on the Commission's legislative proposal on Key Information Documents (KIDs) for Packaged Retail Investment Products (PRIPs), which expands on the ideas in our October 2012 position paper, "Towards Suitable Investment Decisions?"

There is a growing body of evidence that intervening at the point of sale is not always sufficient to achieve effective retail investor protection.
The FSA noted in a recent report[1] that their "*general philosophy has previously been to accept that most retail financial products are suitable for some consumers and so we should not intervene in their design. We saw it as our role to make rules and supervise the market at the point of sale to stop products reaching the wrong consumers, rather than questioning their design. (..). This approach has not always achieved the right customer outcomes: in some high-profile cases, consumers have suffered significant detriment. We believe a new regulatory approach is needed to avoid these large-scale episodes of consumer detriment."*

Such results are not surprising as retail investors exhibit a low level of financial literacy, many financial advisors do not understand all the risks in the products that they sell, and behavioural economics evidenced investors' biases in decision making and the larger role of psychology over information in financial capability. Finally, there is a huge difference between understanding how a product works and being able to assess the risks attached.

In Great Britain, the regulator recently looked at 173 sales to SMEs of interest rate derivatives[2] and found that over 90% of the sales did not comply with regulatory requirements. A significant proportion of these 173 cases are expected to result in redress being due to the customer.
In France more than 5000 municipalities and regional authorities[3] purchased structured financial products from one single bank, leading in some cases to massive losses, related increases in local taxes and several cities nearly defaulting.
In Italy[4] dozens of cities and regions entered complex derivative bets, leading to trials and already one city settlement for almost €500 million. These are only some of the mis-selling cases that happened over the past years.

Someone said "a billion here, a billion there and pretty soon you are talking real money". £3.4 billion were recently set aside by one single bank to pay customers that were mis-sold PPI and interest rate hedging products[5].

Mis-selling scandals are incredibly costly for the industry in terms of redress and reputational costs, they are a drain on regulators' resources, and have a very detrimental impact on investor confidence.

[1] FSA product intervention 2011 *www.**fsa**.gov.uk/pubs/discussion/dp11_01.pdf*
[2] http://www.fsa.gov.uk/library/communication/pr/2013/010.shtml
[3] http://www.liberation.fr/societe/01012360988-votre-commune-est-elle-infectee-par-un-emprunt-toxique
Nb: municipalities are classified as retail investors in MiFID II.
[4] http://www.bbc.co.uk/news/business-19545849
[5] http://www.ft.com/cms/s/0/5c89a8da-6f66-11e2-b906-00144feab49a.html#axzz2PIHWCtoK

The vast number of mis-selling cases investigated currently pleads in favour of measures preventing investor detriment before it occurs rather than after, and in favour of measures going beyond disclosure to achieve effective and cost-effective investor protection.

I. PRODUCT RULES: WHY?

a. Consumer detriment and individual responsibility – where to draw the line?

One of the key purposes of investor protection is to enable investors to make informed investment decisions, which we understand as retail investors not being surprised by potential losses, as they will have understood the risks involved when their made their investment choices.
So it is not about preventing losses for investors, as investing involves risk, but merely to ensure that investors understand the risk of loss that they are facing.
Regulation also needs to achieve a balance between freedom of choice, individual responsibility and protection against unsuitable decisions resulting from asymmetry of information or predatory practices.
The vast number of mis-selling cases over the past years suggests that this balance is not yet achieved.

b. What conclusions can we draw from UCITS?

UCITS funds have been in existence for almost three decades now and are a big commercial success since the UCITS III package in 2001. Their success is attributed to their European passport and their sound framework that is valued by investors, even outside of Europe.

Interestingly the UCITS framework includes a Key Investor Information Document, but includes also product investment rules, that define criteria on eligible assets, diversification and liquidity requirement, etc..
These product investment rules are a key element of the soundness of the framework and of the success of these funds. The example of UCITS is also evidence that product rules do not have an adverse impact on choice and innovation but rather contribute to restoring investor confidence and engagement with financial markets.
While it is not desirable to make all investment products UCITS like, restoring investor confidence is precisely what is needed right now and a sound framework going beyond disclosure would contribute to that objective.

II. WHEN AND HOW?

a. Different approaches

One approach that is used in MiFID product intervention and in some Member States is to remain as non prescriptive as possible in order not to limit the scope of intervention. While it is good to avoid narrowing down too much the scope, some claim that a lack of prescription can create regulatory uncertainty, costs and delays in launching new products for the industry. It can also be a burden on regulators resources.

A second approach, used in UCITS and some other Member States is to have a set of clear high level principles on product design. Such an approach is sometimes credited with providing more guidance to the industry and reducing the burden on regulators. However it requires carefully designed principles, for them to be comprehensive enough and stable over time.

A third approach is to put the focus on the broader product governance. Product governance deals with firms' responsibilities in all areas of product development and governance, from identifying targets for the products, to post-sales responsibility.

While a target market approach provides indisputable benefits, we believe that some products are not suitable for any retail customer, as they are inherently flawed. Hence the need to have, within the product governance toolkit, some product design rules.
Here is an actual product that was sold widely to French municipalities, which are classified as retail clients in MiFID.

Royal Bank of Scotland – snowball swap sold to French municipality of Saint Etienne
Every quarter the municipality pays a teaser rate of 3.92% until May 2011
Then it pays every quarter until May 2020 the iterative formula:
If (CMS[6] 20y – 3 month euribor) >= -0.30%, then coupon = previous coupon
If (CMS 20y – 3 month euribor) < -0.30%, then coupon = previous coupon + 3x (0.10% - (CMS 20y – 3 month euribor))
Where CMS 20y = 20 year constant maturity swap benchmark

Every quarter the city receives 9.69% - Min(12% ; Max(10x (CMS 10y – CMS 2y) ; 0))
Source: extract from the Saint Etienne municipality council assembly related to the RBS trial[7]

This product is not an investment product but the mechanism used for comparable investment products is the same.
After an initial teaser rate phase, the product works as follows:
If the spread between the 20 year rate and the 3 month interest rate is equal or above -0.30%, then the city pays the previous coupon, if not the city pays the previous coupon + 3 times the difference between 0.10% and the spread between the 20 year rate and the 3 month rate.
At the same time, the city receives a rate of 9.69% minus 10 times the spread between the 10 year rate and the 2 year rate, capped at 12% and floored at 0%.

[6] The 20 year Constant Maturity Swap is a long term interest rate benchmark
[7] https://www.ville-st-etienne.fr/sites/default/files/deliberations/20121112/DELIB121285.pdf

Here we have a complex mathematical formula referencing four interest rate benchmarks and linking them with an iterative formula that can compound very quickly losses but not gains.
All these features make it extremely unlikely that a retail investor might understand the product.
In addition, the iterative feature of the product plays on a perception bias, as people are usually not good at assessing the impact of multiple compounding.
Lastly the product includes a teaser rate. This feature plays on investors' preference for immediate rewards and their tendency to focus excessively on the attractive initial rate instead of the ensuing conditional return and related risks. This feature has been listed by several regulators as problematic.
We believe that such a product is not suitable for ANY retail investor and therefore should not be offered.

b. Overview of existing Member States national regulations

Product design rules are part of the wider product governance. While product governance deals with firms' responsibilities in all areas of product development and governance, product rules aim specifically at addressing at an early stage investor detriment linked to products or features that are inherently flawed.
As a significant portion of mis-selling cases is related to product failure, and as we are looking at it in the context of PRIPs, this overview is focussed on product design rules addressing this issue within the broader product governance. More specifically it looks at the principles used in national regimes and their possible similarities, with a view to assess whether this can be a sound basis on which to build a common framework.

Five Member States currently have product rules in their national regulation: Belgium, the United Kingdom, Denmark, Portugal and France. Here is a brief summary of these approaches, with a focus on the principles and criteria used to assess the problematic nature of features and products.

The Italian regulator CONSOB also issued guidelines on the distribution of illiquid financial products in 2009, but these guidelines refer more to conduct rules linked to MiFID level 3 than to the product itself, so we have not included them here.
The Dutch regulator AFM issued as well a decree that includes one Article[8] requiring financial institutions to have procedures in place guaranteeing that the development of financial products takes into account the interest of consumers in a balanced way[9]. We have not included it here, as this single article is more about general product governance.

[8] Article 32 https://zoek.officielebekendmakingen.nl/stb-2012-695.pdf
[9] These procedures must ensure that the distribution is tailored to the target group and that scenario analyses are performed.

A. Belgium: FSMA voluntary moratorium on the distribution of complex products[10]

1. Context:

In 2011 the Belgian financial market supervisor requested distributors (intermediaries) to sign a voluntary moratorium committing themselves not to distribute particularly complex structured products to retail investors. This unusual measure will remain in effect until new binding rules on the distribution of structured products to retail investors have been drawn up.
The vast majority of Belgian distributors of structured products signed up to the moratorium.

2. Principles/criteria:

The FSMA/industry moratorium on the distribution of complex products is based on four principles:

1. Is the underlying value accessible?
2. Is the strategy overly complex?
3. Is the calculation formula overly complex?
4. Are the costs, credit risk and market value transparent?

3. Comments:

The first criterion relates to the eligibility of the underlying assets: retail investors must be able to observe the relevant market data of the assets, as is the case for securities dealt on an exchange, indices with sufficient renown and track record and most traditional assets.
The second criterion includes products with a teaser rate, or whose loss potential is larger than their profit potential, or where a small change in the value of the asset has a disproportionate impact on the return, or products with conditional capital protection.
The third criterion is about products whose return calculation formula involves more than three mechanisms.
Lastly the fourth criteria affects products whose costs, market value and issuer name are not disclosed clearly.

[10] http://www.fsma.be/en/Article/nipic/~/media/Files/fsmafiles/press/2011/nipic/en/fsma_2011_02.ashx

B. France: AMF warning label

1. Context

In 2010 the French supervisor issued a position on the direct marketing of excessively complex products[11]. The AMF considered that structured funds and complex debt securities fulfilling the three criteria below present such strong mis-selling risks that it would be very difficult for investors to understand the nature and risks of the instruments and thus to make informed investment decisions.

Therefore the advertisements and marketing material of these products must include a specific warning: "The prospectus of this complex security has been endorsed by [name of regulator], however the AMF deems this product to be too complex to be sold to non-professional investors and has therefore not examined its marketing material". This position includes sanctions in case of non-compliance.

The French supervisor ACP issued a similar recommendation for unit linked insurance products invested in formula funds, structured funds and complex debt securities.

2. Principles/criteria

1. The financial instrument offers protection at maturity for less than 90% of the capital invested[12]
2. The face value of the initial subscription amount is below €50,000
3. The financial product fulfils one or more of the 4 following criteria:

a. Poor presentation of the risks and payoff profile of the product;

b. Retail clients' lack of familiarity with the financial instrument because of the underlying assets used;

c. The payoff profile depends on the simultaneous occurrence of several conditions across two or more asset classes; and

d. The risk that clients will not understand the financial instrument being offered, linked to the number of mechanisms in the formula for calculating the financial instrument's payoff.

3. Comments

The first and second criteria ensure that only products including significant risks and sold to retail investors are covered here.

The 3.a criterion applies to products whose risk and return profile is presented in an unclear or misleading manner, taking advantage of investors' shortcomings.

3.b deals with eligible assets and aims at ensuring that assets unusual for non-professional investors such as correlation and volatility products are not offered.

3.c applies to products requiring an assessment of complex scenarios to evaluate the risks.

3.d applies to products whose return mechanism is highly complex.

Our understanding is that the choice of this warning label over other regulatory approaches was linked to the difficulty of imposing product bans.

The AMF approach however proves efficient since manufacturers in most cases stopped producing products that would be required to display the warning label.

[11] http://www.amf-france.org/documents/general/9662_1.pdf and http://www.acp.banque-france.fr/fileadmin/user_upload/acp/publications/registre-officiel/Recommandation-2010-R-01-de-l-ACP.pdf

[12] For unit linked insurance products, the protection must be during the whole life of the product and there is no condition on the initial subscription amount. All other criteria are identical.

C. UK: FSA temporary product intervention rules

1. Context

The UK FSA published a discussion paper on product intervention in 2011[13], adopting a new regulatory approach involving earlier intervention to ensure that new products truly serve the needs of investors.

This paper includes a non-exhaustive list of typical indicators of problematic product features, based on its observations of past mass consumer detriment and market failure analysis. These indicators are seen as warnings that a product might be detrimental, usually when several of them are combined.

The FSA also more recently published non-binding guidance on general governance[14] and on retail structured product governance. This guidance has a broader scope from the generation of product ideas, to the information to be provided to distributors and consumers, to post-sales responsibility. It focuses on manufacturers and distributors' responsibilities, such as identifying the target audience for products, stress-testing new products to ensure that they deliver fair outcomes, and having in place robust product approval processes.

Lastly the FSA published last month a policy statement on the FCA's use of temporary product intervention rules[15]. These rules are meant to be used where an identified risk of consumer detriment requires prompt action. Possible actions range from warnings to requirements to amend promotional material, to bans of particular product features or products, when they are inherently flawed. Products which exploit systematic demand-side weaknesses are notably likely to be subject to temporary product intervention rules.

2. Principles/criteria

FSA's indicators of problematic product features (non-exhaustive list)

General

• Complex products, including bundled products or those with opaque structures.
• The decision to buy is secondary or tertiary following another purchase.
• The product cross-subsidises other products.
• The product carries an inherent conflict of interest that is potentially damaging to consumers.
• The product's inability to meet customer needs would not be apparent until a considerable time in the future.
• Products with secondary charges (e.g. charges contingent on events throughout the life of the product).
• Layers of charging due to multiple products or services included in the package.
• Products where the customer is attracted by a teaser rate and then tied in.
• Exit charges or other features which act as a material barrier to exiting.
• Bundled products with a limited overlap of the target markets for each of the products.
• Products aimed at consumers facing financial hardship.
• Product features outside the core range (e.g. 'bells and whistles' or 'gimmicks' of little use to most customers or at significantly higher margin).

Insurance

• Factors affecting eligibility to claim risk undermining the utility of the product or excluding large groups of customers.

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[13] [13] FSA product intervention 2011 *www.**fsa**.gov.uk/pubs/discussion/dp11_01.pdf*

[14] The Responsibilities of Providers and Distributors for the Fair Treatment of Customers
Retail Product Development and Governance – Structured Product Review

[15] http://www.fsa.gov.uk/library/communication/pr/2013/028.shtml

• Circumstances in which the provider can withdraw cover risk undermining the utility of the product.
• Limited risk transfer to the insurer.
• Complex claims notification procedures that will deter claimants.

Investments

• Use of non-standard assets for investment purposes.
• Use of product names that imply greater levels of safety/return than are actually possible.
• Charges that do not appear to reflect the level of service provided e.g. a passive collective investment scheme with a high annual charge.
• Performance risks that are difficult to assess or are not properly understood by the provider or distributor[16].

FCA examples of products exploiting demand-side weaknesses

• a product, or a feature of a product or group of features, might be so complex that most consumers, or a particular type of consumer, would be unable to understand, or would have difficulty understanding the risks or features of the product they are purchasing, with the result that the appropriate outcomes are unlikely to be achieved;
• certain product features which are not integral to the effective operation of the product might unduly restrict search or switching;
• some features may be designed to exploit consumers' focus on the headline price or other near-term features, as opposed to outcomes in the long term;
• a product may be designed to frame consumer choice in a potentially misleading way;
• certain products may represent an irregular purchases or one-off purchase over a customer's lifetime, and consumers may have difficulty in applying competitive pressure to providers, for example by switching; and
• products may be bundled (sold as a group of products for a single price) or tied (where the sale of a product is conditional on another sale) in a way that creates the potential for consumer detriment, by unduly restricting the consumer's access to individual components where the other elements of the bundled or tied products may not be useful to – or valued by – them.

3. Comments:

We would classify the features that are problematic or that exploit demand-side weaknesses in four categories. Please note that it is only our interpretation:

a. *Assets eligibility*: e.g. the use of non-standard assets for investment purposes.

b. *The complexity of the return mechanism*: e.g. unnecessary complexity not benefiting the investor, performance risks that are difficult to assess.

c. *Packaging features taking advantage of investors' behavioural biases*: e.g. teaser rate, products designed to frame consumer choice in a potentially misleading way, complex cost structures and claim procedures, "gimmick" packaging features, use of product names implying greater safety than possible.

d. *Product features undermining the utility of the product*: e.g. features affecting eligibility to claim risk, or limiting the risk transfer. These features might arguably be included in the category (c): these are products claiming to offer some benefits but that include such limitative conditions that their utility is debatable and that also play on the fact that retail customers are unlikely in most cases to be able to assess and remember these conditions until after they have experienced them.

[16] There is also a category on mortgages, however since this type of product is outside the PRIPs scope, we have not reproduced it here.

D. Denmark: risk labelling of investment products:

1. Context

An executive order has been issued in 2011 on the risk labelling of investment products[17]. It requires financial intermediaries selling investment products to retail investors to provide information about risk labelling of the types of investment products that they sell or for which they provide investment advice.

The risk labelling classifies exhaustively financial products into three categories. Each financial product is labelled "green", "yellow" or "red". Products labelled red are those where the investor could lose more than the amount invested or product types that are difficult to understand. In case of non-compliance the Danish FSA can issue correction orders or can impose fines.

2. Principles/criteria

Green label:

a. Investment products where the risk of losing the whole amount invested must be considered as very small, if the investment is held to maturity.
b. This product type is not difficult to understand.

Yellow label:

a. Investment products where there is a risk of wholly or partly losing the amount invested.
b. This product type is not difficult to understand.

Red label:

a. Investment products where there is a risk of losing more than the amount invested, or
b. Product types which are difficult to understand.

3. Comments :

The Danish approach is different in that it classifies all products into categories rather than identifying problematic features. However it follows two criteria in its classification approach, namely whether or not *the product is difficult to understand* and whether *the investor can lose more than the amount he invested*.

A list of the products in the red category can be found in Annex 1.

Some argue that this approach could be problematic, for example as a Greek sovereign bond would get a green light whereas a capital protected note with minor yield enhancing features would be red.

[17] http://www.dfsa.dk/en/Regler-og-praksis/Translated-regulations/Executive-Orders/~/media/Regler-og-praksis/2011/EO345_2011.ashx

E. Portugal: warning symbols and notices for complex financial products and unit-linked insurance plans

1. Context

In November 2012 Portugal established a specific information regime for complex financial products and unit-linked insurance plans, including a detailed key information document and disclosure duties for advertising documents[18].

A key information document must be drawn up for complex financial products with a minimum capital subscription of less than €100,000. This key information document and advertisement material are required to include a warning symbol and a warning notice:

2. Principles/criteria

a) **Green colour** – Green may only be assigned to the CFP[19] with guaranteed income when issued or guaranteed by an entity subject to prudential supervision in the European Union or covered by the mutual recognition system.

b) **Yellow colour** – Yellow may only be assigned to the CFP with guaranteed income that are not issued or guaranteed by an entity referred to in the preceding paragraph and also to CFP where maximum loss of capital at maturity is less than or equal to 10% of the capital invested.

c) **Orange colour** – Orange is assigned to the CFP where there is a possibility of recording a capital loss at maturity that is greater than 10% and less than 100% of the capital invested.

d) **Red colour** – Red is assigned to all CFP where there is a possibility of recording a capital loss greater than or equal to 100% of the capital invested.

Depending on the colour of the warning symbol applicable and the conditions laid down, the following additional phrases are required:

a) **Green colour** – In the case of the CFP without capital guarantee at all times, *"Involves the tying up of capital for [insert deadline, if certain, or the maximum period, if uncertain, of the tying up of capital required to obtain the guaranteed income]"*;

b) **Yellow colour** – Depending on whether the CFP with guaranteed income or at risk of partial loss of capital, the phrase *"Involves the tying up of capital for [insert deadline, if certain, or the maximum period, if uncertain, of the tying up of capital required to obtain the guaranteed income]"* or *"Risk of losing up to 10% of the invested capital"*, respectively;

c) **Orange colour** – *"Risk of losing more than 10% of the invested capita""*;

d) **Red colour** – *"Risk of losing entire capital invested"* or *"Risk of losing more than the capital invested"*, as applicable.

3. Comments :

The Portuguese approach shares significant similarities with the Danish one.

It is focused on providing enhanced disclosure highlighting the risks. Its warning symbols are akin to a summary risk indicator.

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[18] CMVM Regulation No. 2/2012 Complex Financial Products - http://www.cmvm.pt/EN/Legislacao_Regulamentos/Regulamentos%20Da%20Cmvm/2012/Documents/RegulamentoPFC2_2012E.pdf

[19] Complex financial product

F. Summary:

	PURPOSE	SCOPE	REGULATORY APPROACH	CRITERIA	SANCTIONS
BELGIUM	Lead to a more transparent and simpler product offer	Structured products, including insurance contracts and deposits, considered particularly complex	Voluntary moratorium until new rules on the distribution of structured products have been drawn up	- Asset eligibility - Complexity of the strategy - Complexity of the payoff formula - Transparency of cost, risk and value	- Name of distributor removed from list - Once regulation is in place additional sanctions are expected
DENMARK	Ensure that consumers get clear information and understand their risk of loss	All investment products Insurance products are excluded	Mandatory provision of risk labelling information	- Product difficult to understand - Risk of losing more money than invested	- Pecuniary sanctions - Correction orders - Criminal liability
UK	Intervene earlier in the product value chain, analyse product design and governance, to anticipate and stop consumer detriment before it occurs	Deposits Insurance policies Investment products Mortgages	Range of options, from monitoring of conduct and strategy, testing of firms' product governance processes to additional options including product banning where required	- Asset eligibility - Complexity of the payoff formula - Packaging features playing on behavioural biases - Features undermining the product utility	Range of enforcement tools from cancelation of a firm's authorisation to carry out a regulated activity, to disciplinary action and financial penalties
FRANCE	Address information asymmetries, clients difficulties in understanding the products and failures of intermediaries to comply with their obligations	French and foreign structured funds (incl. UCITS) complex debt securities except warrants unit linked insurance invested in the above	Mandatory language warning for products deemed too complex to be sold to non-professional investors	- Capital guarantee > 90% - Initial subscription<=50k€ - Presentation of risk/return - Asset eligibility - Complexity of the payoff scenarios - Complexity of the payoff formula	Sanctions imposed by AMF Enforcement Committee
PORTUGAL	Address understanding issues linked to extremely complex financial products	Complex financial products, including derivatives, structured capital at risk debt securities, certificates, unit-linked insurance funds, dual products	Mandatory provision of warning symbols and notices, on a key information document and on marketing material	- The percentage of the capital invested that can be lost - Whether the issuing / guaranteeing entity is subject to EU prudential supervision	Pecuniary sanctions

We draw the following conclusions from this brief overview:

- the purpose of all five national regimes studied is very similar: they all aim at reducing consumer detriment before it occurs rather than after by ensuring that the products on offer enable retail investors to make informed investment decisions.

- their scope and regulatory approaches differ: the focus varies from product design rules with clear principles to broader product governance. However these approaches are not contradictory but complementary: governance rules aim at preventing investor detriment in general, resulting from poor selling practices, ineffective product governance or product failure. Within it, product design rules target specifically issues related to product failure.

- their requirements differ: The Danish, Portuguese and French approaches are about disclosure, and leave the ultimate choice to the investor.
Within these three, we understand that the French warning label has the strongest impact, leading to most manufacturers no longer producing products that would have to display the warning.
The British approach puts the responsibility on the financial institutions and has a flexible range of tools from warnings to bans. And finally the Belgian moratorium that is in effect a ban provides clear guidance to the industry while protecting effectively retail investors.

- their criteria share significant similarities: the British, Belgian and French approaches include criteria related to the complexity of the return mechanism, criteria on asset eligibility and criteria on features exploiting behavioural biases / investors shortcomings.
The Danish criterion assessing the difficulty to understand the product overlaps partly with the criterion about the complexity of the return mechanism. The other Danish criterion about the loss potential being smaller or larger than the amount invested shares some similarities with the UCITS product rule capping the level of risk in the investment product. The same goes for the Portuguese criterion about loss potential.

We conclude that while their scope and regulatory approaches are different, existing national product rules share a common purpose and their tried and tested principles share significant overlap. This should facilitate agreeing on a set of common principles.

III. FINANCE WATCH PROPOSAL

Based on these existing product rules, we would ***suggest the following six principles*** that are about asset eligibility, excessive complexity of the return mechanism, packaging features playing on behavioural biases, ensuring balanced outcomes and capping the level of risk in the product.

Investment products shall be considered not suitable for retail investors if one or more of the following conditions are met: 1. The product invests in underlying assets not commonly invested in by non-professional investors; 2. The final return is conditional upon the occurrence of events uncommon for non-professional investors, such as the level of regulatory capital of a financial institution; 3. A number of different mechanisms or asset classes are used to calculate the final return on the investment, creating a risk of misunderstanding on the part of the investor; 4. The investment return includes packaging features which take advantage of investors´ behavioural biases, such as teaser rates and iterative pay-off formulas; 5. The global exposure of the financial product, measured by its monthly Value-at-Risk calculated within a 99% confidence interval at the time of trade, is above 20%. 6. The investment product does not provide fair and balanced outcomes for the investor.

<u>Principle (1): is about ensuring that retail investors can access all the traditional assets, but are not offered excessively complex or exotic assets, such as correlation.</u>
Example 1: A financial instrument where performance is linked to the correlation over a certain period between an oil company's share price and the level of a commodities index.
→ In this case, the investor must be able to anticipate changes in the correlation between a share and the underlying index, which generally requires a high level of expertise.

<u>Principle (2): is about ensuring that the return is not conditional upon the occurrence of events that non-professional investors would not be able to assess.</u>
Example 2: A contingent convertible bond that automatically converts into shares if the regulatory capital of the issuing bank declines below 5%.
→ Assessing the probability of regulatory capital declining below a specific predetermined level would require a high level of expertise from the investor.

<u>Principle (3): is about excessive complexity</u>
Example 3: A financial instrument that offers the average performance of the CAC 40® index over a five-year period at maturity, plus or minus an annual coupon payment that depends on the performance of the bond market:
i) For each year where the CMS 10 year® rate is more than 55 bp higher than the CMS 2 year® rate, and the CAC 40® index posts a gain, a 4% coupon is paid at maturity.
ii) For each year where the CMS 10 year® rate is less than 20 bp higher than the CMS 2 year® rate and the CAC 40® index posts a loss, the final return is reduced by 1%.
→ Two asset classes determine the ultimate performance of this financial instrument: equities and fixed income. It is difficult, if not impossible, for retail clients to grasp the market scenarios that they should be anticipating.

Example 4: Product with the following payoff profile at maturity:

i) The average quarterly performance over 5 years of a strategy index that overweighs the 20 highest-performing CAC 40® stocks in the previous month and underweights the 20 lowest-performing stocks.
ii) If, at a set quarterly date, the index is up by more than 10% over the previous quarter, a 6% coupon or bonus will be paid at maturity.
iii) If at a set quarterly date, the index is down by more than 30% from its starting level, then the product is liquidated (or terminated) and redeemed before maturity. In this case, the full decline in the index is subtracted from the initial capital outlay, and any bonuses acquired in the previous quarters are added.
→ High risk of misunderstanding. Four different mechanisms come into play in the calculation of the final return: the effect of averaging, a strategy that is intrinsic to the underlying index, a bonus for exceeding an upper bound and a loss for exceeding a lower bound.

Principle (4): is about products exploiting investors' shortcomings.
Example 5: A financial instrument guaranteeing during the first 2 years a fixed coupon of 6%, followed by a variable rate of return conditional upon the realization of certain events.
→ Packaging features like the described "teaser rate" play on the behavioural biases of retail investors, in this case on the preference for immediate attractive returns. It creates a risk that the investor will focus unduly on this feature without fully realizing the related future risks.

Example 6: A structured note whose quarterly coupon is paid according to the following formula: Coupon = previous coupon + 5x Min(CMS 10y – CMS 2y ; 0).
→ The iterative nature of the return can compound losses but not gains at a quick rate, which would be very difficult if not impossible for most retail investors to anticipate.

Principle (5): aims at capping the level of risk in the product at a level similar to UCITS.
The proposed 20% monthly VaR cap is consistent with UCITS and aims at limiting the leverage of investment products sold to retail investors.

Principle (6): targets products where there is a strong unbalance between the potential for gain and the potential for loss.
Products including limitative conditions undermining significantly their utility, or products whose probability weighted positive and negative potential returns at trade date are significantly unbalanced: a strong unbalance between the potential for gain and the potential for loss is an indication that the manufacturer or distributor took an unfairly large share of the return, to the detriment of the investor.

We believe that such principles would have prevented the mis-selling case related to the second example described in this document and many of the mis-selling cases currently underway in Member States.

For consistency purposes with UCITS where binding product investment rules are in effect a product ban, we would be inclined to follow a similar approach and use such principles for product ban: as UCITS represent 60% of PRIPs, we feel that having hard rules on 60% of the scope and enhanced disclosure on the rest, even though the risks are similar, might create a suboptimal double standard.
However should there not an agreement for such an approach, we would need at minima a warning label based on these principles on the KID. This softer alternative would only be about disclosure and would leave the ultimate choice with the investor.

IV. POTENTIAL CONCERNS

a. What impact on the industry?

Is it possible to achieve an effective reduction in mis-selling with a neutral or positive impact on the industry?
Based on the evidence from UCITS, we believe that these 2 objectives are not incompatible at all.
First as discussed such rules would not prevent innovation and choice, but merely ensure that innovation benefits the investors.
Such rules might lead in some cases to a shift from complex products to simpler and cheaper alternatives. This would not however affect the overall profitability of institutions as they would adjust their product offer accordingly.
Rules should also contribute positively to reducing redress costs and reputational costs for manufacturers, which start to be a meaningful issue affecting their bottom line.
Even more important, a sound framework would have a positive impact on restoring investor confidence and engagement with financial markets, which would be very positive for the industry.

b. Is PRIPS the place to do it?

Such principles should be applicable to the whole scope of PRIPs, irrespective of any possible reduction or widening of scope compared to the Commission proposal.
Evidence from mis-selling cases shows that suitability issues are often as not linked to excessively complex products, but also to detrimental features playing on investors' shortcomings or providing unbalanced outcomes. We thus believe that the scope of product design rules must not be only structured products but rather the whole scope of PRIPs.
Since such rules are not related to advice but to product design, we are convinced that PRIPs is the place to introduce them.
This would also be consistent with UCITS, whose product investment rules are complementary to MiFID product intervention measures, and product design rules within PRIPs should similarly be a useful complement to MiFID product intervention.

c. Additional questions:

Adding this new dimension to the file raises three other questions:

- Might it not create too big a burden on regulators? We believe that it might be the case if regulators have to preapprove each product, but we believe that a set of clear principles providing ex ante guidance would prove less resource consuming.

- On the impact on the PRIPs timeline, the fact that existing national regulations share a common purpose and their principles have significant overlaps should facilitate agreeing on a set of common principles without delaying excessively the file. More importantly the PRIPs level 1 text would only include high level principles, and detailed guidance would be provided at level 2.

- Regarding the impact assessment, we already have data from UCITS and national regimes that show the positive impact of such rules; however an impact assessment is necessary and should be provided before the drafting of level 2 technical standards on these rules.

IV CONCLUSION

Based on the above, we draw the following conclusions:

The many mis-selling cases in EU Member States and failure of interventions at the point of sale to always achieve the desired level of investor protection bring the conclusion that ***intervening at an earlier stage in the product design is necessary***.
Evidence also shows that it is preferable for all stakeholders to ***prevent consumer detriment before it occurs*** rather than after[20]. The cost and length of mis-selling trials is indeed suboptimal for all parties involved.
As a significant portion of mis-selling cases is related to product failure, this requires in our view action targeted at this specific issue, which does not preclude wider product governance rules.

Existing Member States product rules ***share a common purpose, and their tried and tested principles have significant overlaps***. This should facilitate agreeing on a set of common principles without delaying much the PRIPs file.
We believe that ***PRIPs is an opportunity not to be missed to get it right with investor protection*** and to address meaningfully mis-selling issues. We find it thus important to support amendments proposing the introduction of product rules within this proposal.

[20] We understand that the European Supervisory Authorities are in fact already working on this issue through ESMA's Financial Innovation Standing Committee and its subcommittee on consumer protection.

ANNEX I: Danish FSA executive order classification of products:

Red products:
- Hedge fund certificates regardless of the underlying investment product.
- Mortgages.
- Shares not admitted to trading on a regulated market (including trading on multilateral trading facilities (MTF) and alternative markets).
- Corporate bonds not admitted to trading on a regulated market (including trading on multilateral trading facilities (MTF) and alternative markets.
- Certificates where more than the amount invested can be lost.
- Exchange Traded Notes, where more than the amount invested can be lost.
– Non-UCITS.
- Shares in, for instance, ships, property projects, etc.
- Structured bonds.
- Options, futures and forward transactions on for instance: currency, shares, bonds, other securities, returns, interest rates, indexes and commodities.
- Interest-rate swaps.
- Swap options.
- Share swaps and swaps on share indices.
- Currency swaps (exchange of payments in different currencies).
- Inflation swaps.
- Commodities swaps.
– Total Return Swaps.
– Contracts For Difference (CFDs).
– Credit Default Swaps (CDSs).
- Future interest-rate agreements (FRAs).
– Exchange Traded Funds (ETFs).
- Any other derivative agreement relating to climatic variables, freight rates, emissions permits or inflation rates or other economic statistics.
- Any other instrument covered by Annex 5, nos. 4-11 of the Financial Business Act.
- Rights to subscribe for investment products in the red category.