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**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN  
PARLIAMENT AND THE COUNCIL**

**PACKAGED RETAIL INVESTMENT PRODUCTS**

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# COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

## PACKAGED RETAIL INVESTMENT PRODUCTS

(Text with EEA Relevance)

### 1. INTRODUCTION

'Packaged retail investment products' provide retail investors with easy access to financial markets. The regulatory framework for these products must provide a robust and coherent foundation for effective and responsible retail investment. The financial crisis has provided a stark reminder of the importance of transparency in financial products and of the potential costs of irresponsible selling. A collapse in investor confidence has underlined the urgency of ensuring the right regulatory framework is in place, so that the rebuilding of confidence can occur on a sound basis.

A substantial body of Community law already exists to protect investors. However, legal requirements on product transparency, sales and advice differ according to the legal form of the product and the distribution channel. This situation does not provide a coherent basis for the protection of the retail investor or for the balanced development of the market for packaged retail investment products. The level of protection afforded to the retail investor should not vary according to the legal form of these products.

This Communication marks the conclusion of work that began following an ECOFIN Council request to look at these issues in May 2007. The work has included a call for evidence in October 2007, a Feedback Statement in March 2008, a technical workshop with industry representatives in May 2008, and a high-level Open Hearing in July 2008.

This Communication explains the steps the European Commission will take to bring the European legislative framework for mandatory disclosures and sales practices for packaged retail investment products into line with market reality. The objective is to introduce a horizontal approach that will provide a coherent basis for the regulation of mandatory disclosures and selling practices at European level, irrespective of how the product is packaged or sold.

This work aims to ensure that markets for packaged retail investment products are driven by greater transparency, better explanation of proposed investments, and product sales which are aligned with investor interests. It will provide a market in which regulatory arbitrage does not drive savings towards particular products.

This work will help to start rebuilding investor confidence in packaged investment products – which has been severely dented by the financial crisis. Assets invested in the most common packaged retail investment products have declined from €10 trillion at end-2007 to estimates of around €8 trillion at end 2008 under the influence of asset write-downs and investor withdrawals. In view of this, the present Communication forms part of the reform measures to address the shortcomings in regulation laid bare by the financial crisis published by the European Commission in its Communication ahead of the Spring European Council.

## What are packaged retail investment products?

Retail investment in the financial markets is currently largely channelled through 'packaged' retail investment products. These products can take a variety of legal forms which provide broadly comparable functions for retail investors:

- They offer exposure to underlying financial assets, but in packaged forms which modify that exposure compared with direct holdings;
- Their primary function is capital accumulation, although some may provide capital protection;
- They are generally designed with the mid- to long-term retail market in mind; and
- They are marketed directly to retail investors, although may also be sold to sophisticated investors.

Many retail investors look across all the relevant product families when identifying suitable investment options. This opportunity is increasingly facilitated by banks and other distribution systems which sell a wide range of investment products. Box 1 describes the main product families that fall under this heading. These product families differ in their tax treatment and form of investment proposition. The appropriate choice of product for any given investor will depend critically on his or her profile, varying by financial situation and investment needs, family circumstances, age, tax profile and risk appetite.

The list below is not exhaustive. New investment products are constantly emerging. These are not the only investment products suitable for the retail market. The description and list nonetheless serve as a starting point for identifying packaged retail investment products for the purposes of this initiative.

### **Box 1: Families of Packaged Retail Investment Products**

*The product descriptions that follow are indicative only; in most cases, there are currently no widely-accepted legal definitions of the product families in question.*

- **Investment (or mutual) funds.** Investment funds are a form of collective investment vehicle that invest the pooled funds of a large number of investors for a fee. Funds raise money by selling 'units' of the fund to investors. In the EU, investment funds can be either UCITS ('Undertakings for Collective Investment in Transferable Securities', as harmonised by the UCITS Directive), or nationally regulated funds (non-harmonised funds or non-UCITS).
- **Investments packaged as life insurance policies.** In unit-linked life insurance policies a portion of the premium is used to purchase life cover (the sum assured) with the balance invested in a fund such as a UCITS. The return on the policy is linked to the performance of the funds. As opposed to traditional life insurance products, unit-linked policies usually do not guarantee the payment of a determined financial amount in particular in the case of death / survival, but instead an amount which is a multiple of the market value of one or several units. Therefore, by definition, the policy holder bears the investment risk.

- **Retail structured securities.** Structured securities are derived from or based on a single security, a basket of securities, an index, a commodity, a debt issue and/or a foreign currency. Normally in a structured security an investment bank promises to make, at a pre-determined time, a payout based on a pre-determined formula. The majority of structured securities offer full protection of the principal invested at the end of their term, whereas others offer leveraged returns but limited or no protection of the principal. They may be sold to investors as, *inter alia*, certificates, structured notes (bonds) or warrants.
- **Structured term deposits.** Structured term deposits offer a combination of a term deposit with an embedded option or an interest rate structure. They are designed to achieve a specific payoff profile, which they achieve through transactions in derivatives such as interest rate and currency options.

A variety of financial institutions are involved in the process of manufacturing and selling these products to retail investors, spread across multiple sectors of the financial services industry. Fund managers, insurance companies and commercial and investment banks structure and manage these products. They distribute them to retail investors either directly, or via a network of financial intermediaries, including brokers, insurance intermediaries and independent financial advisers.

### **Risks to retail investors**

In a well-functioning market, competition between investment products can yield considerable benefits for retail investors and the economy at large. Competitive forces can sharpen incentives to deliver products that respond to changing market conditions and the evolving needs of investors.

The packaging of investment products can also provide specific benefits, for instance by offering retail investors with opportunities for spreading risk or targeting specific risk and reward outcomes, or by providing access to professional investment management expertise, in ways that would be impractical or costly through direct investments.

However, there is a sharp asymmetry in information and expertise between the manufacturers and distributors of products and retail investors, and the latter typically exhibit a relatively low level of financial sophistication. The act of 'packaging' investments can increase this asymmetry, for instance by adding complexity that makes key investment characteristics less transparent and introducing additional layers of cost which may not be readily apparent.

In view of this, consumers must rely on a combination of product information supplied by product manufacturers with services such as advice provided by distributors and financial advisers.

Unclear or incomplete disclosures can increase the selection of inappropriate or misunderstood products. Similarly, if selling processes and financial advice are not focussed on the needs of the client, unsuitable products may be sold. This may be more prevalent where the interests of sellers and buyers are not aligned, for instance, where product originators provide financial incentives to distributors or advisors to sell their products.

These risks of investor detriment, whether in the form of direct financial losses or the opportunity costs of inappropriate investments, could undermine consumer confidence in packaged retail investment products.

## **Regulating product disclosures and the sale of packaged retail investment products**

In view of these potential risks to retail investors, regulation has been introduced at European and Member State level.

This is achieved in some cases through regulation of the products themselves, for example by limiting the access of retail investors to certain product types or by restricting the assets in which retail investment managers invest. While successful in certain sectors, this approach is difficult to implement effectively in the face of financial innovation.

Regulators have therefore more typically focused on enabling better investor decision making, by concentrating on rules in two areas:

- the form and content of key investor **disclosures** and associated marketing materials that are provided to investors before they make an investment decision. Increasing importance is attached to summary disclosures which describe the key features of the investment proposition (costs, expected risk-reward etc) and which are targeted at meeting the information needs of retail investors;
- the conduct of business of product distributors and the avoidance, management and disclosure of conflicts of interest in the sales or advice process (**selling rules**).

Such rules do not guarantee good investment decisions. Neither can they protect against adverse investment outcomes, given the market risk integral to most investment products. However they can minimise the risk of investors experiencing adverse outcomes about which they were not forewarned.

An essential complement to these rules is the ongoing drive to improve the level of **financial education** among retail investors in the European Union, as a means of equipping the least sophisticated investors for financial decision-making. However, financial education is not an alternative to clear responsibilities for investment product originators and intermediaries.

## **2. IS THE EUROPEAN LEGAL FRAMEWORK FIT FOR PURPOSE?**

Community law contains many disparate provisions touching on the institutions originating, distributing and selling packaged retail investment products.

Regulation of mandatory disclosures and selling practices at European level is achieved through a combination of sectoral directives in the securities, insurance and fund sectors; and cross-cutting legislation targeting particular sales channels or commercial practices. Most sectoral directives contain provisions on disclosure which are supplemented when relevant by the provisions of cross-cutting legislation. The regulation of sales and advice is dominated by two major pieces of legislation, Markets in Financial Instruments Directive (MiFID) and the Insurance Mediation Directive (IMD). These directives contain rules, *inter alia*, on conduct of business at the point of sale, and the management and disclosure of conflicts of interest.

As Table 1 illustrates, the result is a highly fragmented 'regulatory patchwork' in Community law. Packaged retail investment products are subject to different rules on product disclosure and selling practices, depending on the legal form they take or the channel through which they are sold. Moreover, some products and distribution channels are not currently addressed by Community law.

**Table 1:** Disclosure and selling rules in Community law for packaged retail investment products

	UCITS	Non-harmonised investment funds	Unit-linked life insurance policies	Structured securities and closed-end funds	Structured term deposits
Rules on product information applying to manufacturers, issuers or intermediaries	Simplified Prospectus of UCITS Directive	MiFID  (high-level product disclosure requirements apply to MiFID intermediaries when selling financial instruments)	Consolidated Life Directive	Prospectus Directive	No rules at EU level <sup>1</sup>
	MiFID  (high-level product disclosure requirements apply to MiFID intermediaries when selling financial instruments)		IMD for some product disclosure requirements	MiFID  (high-level product disclosure requirements apply to MiFID intermediaries when selling financial instruments)	
	E-commerce Directive or Distance Marketing of Financial Services Directive				
Selling rules	MiFID	MiFID	IMD	MiFID	No rules at EU level
	UCITS Directive				
E-commerce Directive or Distance Marketing of Financial Services Directive					

**Is the 'regulatory patchwork' a source of concern?**

The European regulatory framework that we have inherited lacks coherence and relevance to the contemporary retail investment marketplace. Inconsistencies and gaps in sectoral provisions reduce confidence that the level of investor protection is sufficiently high across all products.

There are many examples of effective, consumer-focused disclosures and sales centred on consumer needs which deliver suitable recommendations. Despite this there are many episodes of loss due to flawed product design and disclosure or sub-standard selling. Unsuitable products continue to be mis-sold. Products continue to be bought by retail investors who do not have a good understanding of their features.

<sup>1</sup> Further analysis will be needed to ascertain the precise application of requirements depending on the form of the structured product, as it is possible that in some circumstances existing requirements might apply.

The scope of investor losses is difficult to quantify, partly because it will often take the form of an opportunity cost. The Impact Assessment summarises a body of evidence and expert opinion from stakeholders such as consumers and consumer representatives, national regulators and market practitioners. This supports the view that regulatory failures are leading to important investor detriment.

### ***Problems with EU rules on key investor disclosures***

There are significant inconsistencies in the form and content of the summary disclosures for broadly comparable products. There is no consistent approach to providing key information to retail investors on final costs, product risks and rewards, and the conditions attached to capital guarantees.

In some cases, consumers are faced with information which is too technical, badly presented or difficult to understand, creating an 'information overload'. In other cases, existing sectoral disclosure obligations do not work well for packaged retail investment products, as in the insurance sector where mandatory disclosure requirements are designed for the entire universe of insurance products, not those with investment functionality. In yet other cases European rules are entirely absent, as with structured term deposits. These inconsistencies act as a barrier to the effective comparison of the characteristics of different product types and hence to the quality of investor decision-making.

The experience of the financial crisis has underscored the importance of effective disclosures in these areas. It has raised serious questions about investor understanding of the potential for downside risks and counterparty risks inherent in some product guarantees.

It is precisely because of these issues that the European Commission has proposed to replace the Simplified Prospectus currently required for UCITS with a shorter, clearer, and more investor-focused mandatory disclosure, the 'Key Investor Information' (KII) document. KII is being developed with strong stakeholder involvement and has included rigorous testing of disclosure designs with retail investors. This work represents the benchmark for the process of developing improved mandatory disclosures for the whole of the retail packaged investment product market.

### ***Weaknesses in the regulation of selling practices***

European provisions on selling practices seek to ensure both that distributors act professionally and fairly and focus on the needs of the investor when selling or advising on products; and that conflicts of interest are avoided, effectively managed and/or disclosed. This is crucial. A recent survey of investment advisors finds that 72% of respondents believe that the ways in which sales commissions are structured can influence the products which are sold to the investor.<sup>2</sup>

However there are some differences in the disciplines applied by the two major pieces of Community law in this area, MiFID and the IMD. With regard to conflicts of interest, MiFID has introduced a sophisticated regime for the avoidance, management and disclosure of

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<sup>2</sup> CFA Institute European Union Member Poll on Executive Compensation and Retail Investment Products, January 2009.

conflicts of interest and includes detailed provisions concerning the payment of inducements to intermediaries. By contrast, the IMD does not include comparable conflict of interest or inducement rules. It requires intermediaries to tell the customer whether they are giving advice based upon a fair analysis (using a sufficiently large number of insurance contracts) or whether they have contractual obligations with one or more insurers.

Practical experience with both MiFID and the IMD remains limited. Nevertheless, the European Commission is concerned that inconsistencies in the standards of sales practice for retail packaged investment products in these two directives increase the potential for investor detriment and regulatory arbitrage.

Some products and distribution channels are not covered by these directives. Direct sales by product manufacturers (for instance, fund managers or insurance companies) are not subject to the same disciplines as sales by intermediaries. In addition, there are no European rules on the distribution of structured term deposits, which are not financial instruments as defined by MiFID. These gaps generate an unlevel playing field.

### **3. WILL CHANGES IN EUROPEAN LEGISLATION IMPROVE OUTCOMES?**

Are these weaknesses the result of legislative inconsistencies at European level or are they due to other causes such as weak enforcement? Can deficiencies in Community law be adequately compensated by action by Member States or the industries concerned?

Some Member States have already responded to the inconsistencies and gaps in the European regulatory framework by imposing additional requirements on mandatory disclosures and selling practices at national level. Manufacturers and distributors in many sectors have also acted to enhance disclosure documents and to promote responsible selling and advice processes through codes of conduct and statements of best practice.

However, these responses are necessarily limited in their geographical scope. They cannot constitute a co-ordinated or systematic response to the deficiencies of the European legal framework. National regulators are impeded in their attempts to bring greater coherence by inconsistencies in Community law, in particular where the provisions of Community law do not allow for additional national measures to be adopted. This is the case even for those products that are sold on a predominantly local basis.

Moreover, uncoordinated national responses may act as a barrier to the functioning of the single market. For those products for which there are currently no formal provisions harmonising the conditions for cross-border distribution, more consistent EU rules on disclosures and selling practices at the European level may remove some impediments to cross-border retail distribution.

The European Commission has therefore concluded that a systematic and co-ordinated response to the risks associated with the fragmented regulatory framework for packaged retail investment products requires decisive action to be taken at European level. Greater coherence in the European regulatory environment is necessary to deliver a secure and sustainable regulatory environment throughout Europe, and to contribute to the smooth functioning of the single market.

#### 4. WHAT DOES THE EUROPEAN COMMISSION PROPOSE?

The European Commission believes that the existing sectoral patchwork must be replaced by a **horizontal approach to both mandatory disclosures and selling practices**. This approach will promote consistent outcomes regardless of the legal form of the product or the distribution channel employed, and could be extended to continued innovation in the retail market.

An approach based on the modification of existing sectoral legislation and the introduction of new legislation in sectors where it does not currently exist might appear to be less disruptive to existing requirements. However, it would be less effective in delivering a consistent and coherent approach and would perpetuate the risk of incomplete or outdated coverage necessitating further intervention at a later date.

Horizontal measures would not exclude the scope for some adaptation of regulatory requirements to reflect objective differences in product features. Horizontal measures, in the form of Lamfalussy legislation, could combine uniform principles and core requirements for all relevant products or actors, while allowing the detailed content and form of requirements to be adapted to the specificities of different products.

##### **What will a horizontal approach look like?**

The following section sets out the intended approach to developing horizontal rules both for the production of key disclosures by the manufacturers of packaged retail investment products, and the selling of these products by intermediaries or any other distributor, including the product originator. Separate legislative initiatives are envisaged for the two fields of action – principally because different entities are involved in selling and product origination. These separate instruments would need to effectively dovetail with one another.

##### ***Key investor disclosures provided by product originators***

A horizontal approach in this area entails the development of a new instrument, replacing or integrating relevant provisions of existing sectoral rules and extending them to products where no rules currently apply.

The key elements of a horizontal packaged product instrument are described below.

##### **Box 2: Key investor disclosures**

###### ***Objective:***

- The goal would be to achieve as great a degree of harmonisation and standardisation of key retail disclosures as possible to allow for comparison between products, though with some tailoring of detailed rules to the specificities of products.

###### ***Scope***

- The new horizontal instrument would be applicable to all manufacturers of packaged retail investment products. This would be irrespective of whether the product is a re-manufactured form of another underlying product, as where product wrappers are in use.

- Products that are in-scope would be those that fall within the definition of a packaged retail investment product, as provisionally outlined in Section 1.

***Principles on the basis of which the key investor disclosures will be designed***

- Product disclosures should be fair, clear and not misleading. They should be comprehensible to their target investors, who often may have little or no investment experience.
- They should contain the information necessary to take an informed investment decision (e.g. covering performance and risks, charges, guarantees and how the product functions, for instance the existence of fixed maturity dates). To the greatest extent possible they should be designed in a standardised fashion that promotes comparisons between the products.
- They should be presented in a format appropriate for a retail investor: they should be as short and simple (but contain all key information), and be extensively tested with investors to ensure they work as intended.
- The disclosures should be provided to the investor in a timely fashion so as to be capable of influencing the decision as to whether to buy an investment. All who sell packaged retail investment products should be required to provide the mandatory disclosure produced by the product manufacturer to the investor. This obligation would apply to both intermediaries and manufacturers selling their own products; and irrespective of whether a service such as advice is offered in conjunction with effecting the sale.
- Any associated marketing communications should be fair, clear and not misleading, and should be clearly distinguished from the mandatory disclosures while being fully consistent with them.

The recent work on developing KII for UCITS provides a clear benchmark of the standard for mandatory disclosures that is being sought across other packaged retail investment products, though these disclosures would need to be adjusted to reflect the particular features and legal forms of other products. Other work by the Commission, such as on a 'Standard European Consumer Credit Information Sheet' as foreseen in the Consumer Credit Directive, may also provide lessons on the value of standardised pre-contractual information for consumers.

***Selling of packaged retail investment products by intermediaries and other distributors***

The European Commission considers that the right approach is to apply the same legislative requirements across all sales of packaged retail investment products, irrespective of the distribution channel employed. The MiFID provisions on conduct of business and conflicts of interest offer a clear benchmark for such requirements. The extension of these measures to all packaged retail investment products could be achieved by extending the scope of the relevant MiFID provisions so that they apply to all entities selling the relevant products.

The key elements of a horizontal approach to selling practices will be as follows:

### **Box 3: A horizontal approach to the regulation of selling practices**

#### *Scope*

- Consistent conduct of business, inducements and conflict of interest provisions, with MiFID as the benchmark, would be applied to all those selling packaged retail investment products, irrespective of whether the entity is an intermediary or the product manufacturer themselves. Detailed requirements might need to take account of the service being offered (advice, transmission of orders).

#### *Principles*

- Selling practices must be focused on the fair treatment of the investor.
- When an investor receives investment advice, the advisor should undertake the necessary steps to ensure products sold correspond to the profile and needs of the investor, and that the investor understands the nature of the service being provided by the advisor.
- If a product is sold without such advice, the limits to the service provided and risks for the investor must be clearly communicated. An assessment of the adequacy of the product for the investors' needs may still be required in some circumstances.
- For both advised and non-advised sales, conflicts of interest must not adversely affect investors. They should be avoided where possible, or be identified, managed and disclosed in a way that investors can understand.
- For both advised and non-advised sales, investors must receive clear and effective disclosures of remuneration arrangements and all charges, commissions or fees paid, in a form they can use.
- Those assessing the suitability of products must fully understand those products and their features.

### **What are the key challenges in delivering a horizontal approach?**

While the general concept of packaged retail investment products is relatively clear, a general definition will be needed which is sufficiently precise to avoid legal uncertainty and arbitrage. This general definition will need to be supplemented by clear designation of the products that fall within scope. The European Commission recognises the challenge that this represents.

The European Commission does not, however, consider these definitional problems to be insurmountable. In the follow-up to this Communication, a generic definition will be developed and supplemented by a 'white list' of products that fall within or without the scope.

A second key challenge will be the articulation of the new instrument(s) with existing sectoral legislation. New horizontal measures must effectively repeal and replace all relevant existing measures so as to avoid imposing overlapping requirements.

There will also be significant challenges in developing detailed disclosure proposals, for instance for consistent disclosure of product charges, risks and potential rewards where the underlying products can vary significantly in how they work. Experience with the development of improved disclosure for UCITS has shown that this entails considerable detailed technical work and testing of proposals with investors.

The framing of better regulations is by itself not a sufficient condition for achieving the outcomes identified here. Effective cooperation between national supervisory authorities and their consistent and effective supervision of the requirements will be vital. A strong focus on investors' needs by the industry, and improvements in the financial capability of retail investors will also be necessary to build on the improvements in the regulations.

## **5. CONCLUSION**

In the wake of the financial crisis the foundations for future investor re-engagement with packaged retail investment products will need to be laid: people will continue to need to save and invest, and they will continue to need well-managed, secure products which they can understand and which are effectively disclosed and fairly sold to them.

The European Commission recognises that packaged retail investment products serve a significant function both in providing a range of effective investment vehicles for the retail markets, and in promoting efficient capital markets. In this context, product manufacturers and intermediaries have vital roles in building effective and efficient retail markets, helping match potential investors with investments that serve their needs. Product manufacturers and intermediaries naturally need to be remunerated for these roles.

The European Commission believes that a sustainable and satisfactory regulatory environment for the sale and disclosures of packaged retail investment products cannot be established unless the deep seated differences flowing from European legislation are tackled. There are significant challenges in developing this approach, including for supervisors in enforcing and the industry in incorporating new requirements. Great care will have to be taken to minimise cost impacts. A horizontal cross-cutting approach will also imply a need for considerable additional coordination and dialogue between existing sectoral supervisors so as to ensure consistent interpretation and effective engagement with their respective industries.

### **Next steps**

The European Commission will now begin working on detailed proposals for delivering the legislative approach outlined in this Communication. This will involve:

- Gathering technical input to assist preparation of these measures from committees of Member State authorities, technical committees and other stakeholder groupings;
- Launch of studies to inform the preparation of legislative measures and further impact assessment;
- Publication, by end 2009, of a first outline of the possible form and content of the measures described above. This document will be the object of stakeholder consultation.