

**EFAMA's COMMENTS ON THE COMMISSION's CALL FOR EVIDENCE
ON THE NEED FOR A COHERENT APPROACH TO PRODUCT
TRANSPARENCY AND DISTRIBUTION REQUIREMENTS FOR
"SUBSTITUTE" RETAIL INVESTMENT PRODUCTS**

EFAMA¹ is grateful for the possibility to comment² on the European Commission's Call for evidence on the *Need for a Coherent Approach to Product Transparency and Distribution Requirements for "Substitute" Retail Investment Products* issued in November 2007. We congratulate the Commission for the seriousness of the work undertaken by its services and for the very clear description of the regulatory environment pinpointing the differences in European legislation and between different types of savings and investment products.

We are particularly pleased by the fact that the Commission is taking a broad approach not only focusing on certain products, but trying through this consultation to draw up a comprehensive picture of the European retail investment landscape. In our comments to the Commission's Green Paper on retail financial services in the Single Market³ we urged the Commission to transform the political agreement on the need for the creation of a level playing field in administrative practice and legislation. This call for evidence is for us a first but highly important step in the direction and we congratulate the Commission on this.

We also see this initiative as a first change of policy: instead of concentrating only on what are in effect highly regulated and transparent investment funds⁴, the Commission is now starting to examine how the gap separating them from less transparent savings products can be closed, thus bringing the latter up to the same high level of standards.

In our comments of September 2004 on CESR's Advice on possible implementing measures of MiFID, we urged CESR to take care that MiFID Level 2 rules on market communication and advice be equivalent for all comparable financial instruments/products distributed by a firm subject to MiFID and thus provide for an equal treatment of all financial products at the point of sale.

¹ EFAMA is the representative association for the European investment management industry. Through its 23 member associations and 45 corporate members EFAMA represents about EUR 15 trillion in assets under management of which EUR 7.6 trillion managed by around 46000 investment funds. For more information, please visit www.efama.org.

² Our comments are shared by a very large majority of our members, both associations and direct corporate members.

³ COM(2007) 226 of 30 April 2007

⁴ Without, however, giving up going further with the transparency of funds as the current discussion about synthetic risk indicators in the context of Key Investor Information shows.

In our subsequent comments on the Commission’s Green Paper on investment funds⁵ we pointed out that the creation of a level playing field for competing investment products both at distribution and production level to ensure consistent investor protection is one of the most important issues for the European investment management industry.

We have witnessed a huge product shift in the past four years: from entirely different financial products serving different investment needs and aimed at different investors’ categories we have moved to a world of very fast financial innovations where the same content can be packaged in different wrappers and sold to the same investor type, often via the same distribution channels. While the variety and innovation level have grown exponentially, the need to invest for retirement of households has also grown massively, but not their level of financial knowledge. EU regulation structure has also largely failed to evolve (except for MiFID) and is still mostly based on product-by-product regulation which does not establish either equal production or distribution conditions for different financial products and producers. In some cases, there is no EU regulation at all for the product, but only prudential regulation of the producer, and the distribution of the same product is subject to different rules depending on the channel. It is time for EU regulation to evolve beyond MiFID and take the reality of financial markets into account – and the reality facing investors on a daily basis: that financial products should be regulated according to the content, not according to the wrapper, and such regulation should be consistent regardless of the distribution channel.

Current regulation is creating significant distortions in the development and growth of the market for savings products, as it encourages product and distribution channel arbitrage. The Commission correctly focuses on the concerns relating to investor protection, in particular to the issues pertaining to transparency and disclosure. However, the impact of differences in product regulation should not be underestimated, for two reasons:

- They represent a distortion of competition among product providers that would justify intervention at EU level under Article 3 (1)(g) of the Treaty;
- Most importantly, however, differences in regulation such as different rules on eligible assets/underlyings (the eligible assets restrictions on UCITS have no counterpart for structured products, for example) or on cross-border distribution (approval for a UCITS and notification for cross-border distributions take much longer and involved much higher costs than for other substitutable products) also affect the choices made by product providers, favoring the issuance of certain products vis-à-vis others, skewing the availability of products to investors on the basis of higher profitability and time to market and thus reducing investor choices.

⁵ Green Paper on the enhancement of the EU framework for investment funds [COM(2005) 314 of 12 July 2005]

At issue is not the protection from competition for investment funds, but rather the removal of differences in regulatory and tax treatment to the benefit of investors and of the asset management industry in equal measure.

EFAMA is not against competition, as competition is good for business and consumers. However, healthy competition must be fair, and *condition sine qua non* for fair competition is a regulatory level playing field. The achievement of a Level Playing Field in the financial services industry would greatly increase competition, lead to the creation of a truly efficient single market with higher growth rates, and directly benefit investors through better investor protection, lower costs and better products.

In practice, a retail investor does not usually make the decision to buy a specific product, but is looking for a financial solution, a way to reach a financial goal. During the decision process, not all product characteristics are examined, and investors usually give highest consideration to performance and costs. It is therefore imperative that all costs and risks associated with the products be fully disclosed, to enable investors and advisors to make a well-informed investment decision.

Investment funds, in particular UCITS, provide for a high level of investor protection, but this is not always rewarded by the market. On the contrary, many competing products are sold to investors instead of UCITS because of the lack of transparency in the sales process and because their very often hidden margins are higher.

Transparency is without doubt a vitally important factor ensuring investor protection. Investment funds are by far the most transparent investment product, thanks to the provision of the prospectus (full and simplified), the annual and semi-annual fund reports, and to the frequent (mostly daily) publication of fund NAVs. They also offer a very high level of disclosure regarding costs (TER, portfolio turnover rate, entry and exit commissions), as well as investment objectives, risk and performance. By far most of the substitute retail investment products do not offer comparable levels of disclosure.

We therefore fully support the Commission’s initiative to put an end to the “current regulatory patchwork governing product disclosure and intermediary regulation” and to follow the way agreed at the 8 May 2007 ECOFIN Council “to review the consistency of EU legislation regarding the different types of retail investment products (...) so as to ensure a coherent approach to investor protection and to avoid any misselling possibilities.”

In the following we will specify in more detail why this action is needed and what could be done in practice.

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.

Yes, significant problems arise from different regulatory treatment of substitute products on two levels, investor protection and production.

As the statistics provided by the Commission in Annex 2 of the Call for Evidence show, developments regarding substitute products vary from country to country: in some countries life insurance products are particularly strong; in other countries structured products are gaining market share over other products, notably investment funds. The reasons behind these trends are different and depend very much on the national environment. Undoubtedly, often there are tax reasons but it also cannot be denied that the different regulatory treatment has significant impact on the behaviour of distributors.

Investor protection

Undoubtedly, UCITS provide for a very high level of investor protection, making them a unique global brand. Cornerstones for this reputation are very efficient rules to manage the agency risk and strict investment and diversification rules to minimise the investment risk. Regarding the agency risk, there are three crucial rules to protect investors: comprehensive information (including detailed disclosure of fees, not only entry and exit rate, but also TER), efficient supervision of both the fund and the management company, separation of management company and safekeeping of the assets. In this respect, the depositary as described in the UCITS Directive plays a crucial role. Finally, MiFID provides for suitable advice based on the very strong disclosure rules.⁶

Most of the substitute savings products cannot deliver similar investor protection. The distribution of products such as structured notes and certificates is regulated under MiFID, but their product and cost disclosure is – on EU level - regulated by the Prospectus Directive⁷ which asks for a lot of – useful – information but is very “shy” regarding transparency of fees. Indeed, with respect to Annex XII (5.3.) of Commission Regulation 809/2004 implementing the Directive, information must be given only with respect to “expenses ... specifically charged to the subscriber or purchaser”. As transparency of fees is a key feature regarding information on UCITS, it is impossible for the distributor to really compare a UCITS with a structured product.

⁶ See Articles 31 to 35 of Directive 2006/73/EC, the MiFID implementation Directive

⁷ See: Directive 2003/71/EC:
http://ec.europa.eu/internal_market/securities/prospectus/index_en.htm

In this context it must not be forgotten that both the UCITS Simplified Prospectus and the prospectus for a structured product have completely different qualities: while the UCITS Simplified Prospectus must be “offered” to investors and is as such necessary pre-contractual disclosure for UCITS, the prospectus under the Prospectus Directive must only be “published” and is nothing more than an issuance document. The UCITS prospect furthermore requires before approval a verification of compliance of the fund with its rules (substantive check), whereas in the case of structured products the Prospectus Directive only requires regulators to verify whether the prospectus contains the required elements (formal check). Lastly secondary trading of notes often suffers from a lack of liquidity and of transparent pricing. During recent difficult market conditions issuers (which usually also make a market in their products) in some cases stopped providing quotes⁸. As a result, retail investors could not sell their certificates and incurred significant losses. In other cases, issuers took certain certificates from the market informing investors that they will not be paid out before November because of market disruptions⁹.

Other investment products such as unit-linked insurance products are not covered by the strict requirements of either the MiFID or the UCITS Directives, but are regulated by the [consolidated] Life Insurance Directive¹⁰ and – regarding distribution – by the Insurance Mediation Directive (IMD)¹¹, which only includes rather general rules regarding distribution and advice.¹² Indeed, Article 12 IMD states that only those intermediaries who give advice based on the obligation to provide a fair analysis¹³ are “*obliged to give that advice on the basis of an analysis of a sufficiently large number of insurance contracts available on the market ...*”. No mention is made of the facts on which such analysis must be based or about a suitability test.

With respect to Annex III of Directive 2002/83/EC the insurance company must communicate to the policy holder before the contract is concluded only some “basic” information regarding the contract including – in the case of unit-linked policies – information about the units to which the benefits are linked and about the nature of the underlying assets. Fees are not mentioned!

Also banking regulation does not cover either product characteristics or product distribution, but focuses only on prudential regulation of banking entities and on capital adequacy.

On the contrary, it is worth noting that in the United States, under federal law variable annuity and variable life insurance contracts (similar insurance-based products) are considered securities and their offer and sale is subject to regulation by the United

⁸ See: Frankfurter Allgemeine Zeitung (FAZ), 29 January 2008

⁹ See: FAZ 31 January 2008

¹⁰ See: Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance

¹¹ See: Directive 2002/92/EC, http://ec.europa.eu/internal_market/insurance/mediation_en.htm

¹² The problem might be different from country to country depending on how Life Insurance and the Insurance Mediation Directives are implemented.

¹³ Distributors who are under a contractual obligation to conduct insurance mediation exclusively with one or more insurance undertakings do not even need to provide a fair analysis.

States Securities and Exchange Commission (SEC). Generally speaking, this means that variable annuity/life insurance contract owners benefit from disclosure and regulatory protections substantially similar to those that apply to retail mutual funds.

Clearly, the different levels of regulation, often combined with tax discrimination against funds, tend to result in distributors preferring to offer structured products or life insurance products to retail investors. The latter are thus “driven” into products which are less transparent, often delivering a lower performance and – in most cases – providing for a lower level of investor protection.

Production

Also production rules for the above mentioned instruments vary significantly from each other.

While UCITS are subject to the very strict rules set out in the UCITS Directive (diversification & investment limits), this is not the case for structured products or insurance products.

As far as we know, there are no specific rules regarding the production of structured products (for example regarding the “content”) and any assets can be used as underlyings. Also, production in the field of life insurance is less regulated. With respect to Article 25 of Directive 2002/83/EC¹⁴, production seems to be subject only to technical rules and provision on matching liabilities.

Moreover, there is no specification as to the situation in which a contract is linked to the value of assets contained in an “internal fund”¹⁵ held by the insurance undertaking.

Regarding structured products there is also a specific competition issue: as for their producers there are no rules comparable to Article 4 of Directive 85/611/EEC (authorisation of a UCITS), these products can be developed and brought to the market much faster than UCITS. Insurance providers are required to be authorised under the Life Insurance Directive, but the individual products – unlike UCITS which must be individually registered - do not require individual authorisation as they are viewed as a contract between provider and consumer. Promoters of these products are therefore in a better position to react to market developments or new product trends.

It should also not be forgotten that the capital requirements the different producers face in order to “issue” very similar products a very different from each other and that structured notes can be issued by very low capitalized entities.

¹⁴ Which covers contracts linked to UCITS, to the value of assets in internal funds or to a share index.

¹⁵ Article 25 (1) Directive 2002/83/EC

While we understand that national legislators and authorities are doing their best to shorten authorisation delays for UCITS, the differences in time to market are unlikely to fully disappear. Regarding cross-border distribution, the Commission’s initiative regarding the notification procedure for UCITS is in this respect of particular importance.

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 market for retail investment products?

Rather than a threat to the development of the market for retail financial products as a whole, the lack of a level playing field is a threat to a balanced development of the market and to fair competition. In other words, the market will continue to grow driven by an increasing need for long term savings, in particular pension savings, and by the switch from DB to DC schemes where retail investors are looking for an optimal return of investment. However, they might not invest in the most suitable savings products, thereby achieving lower returns. This means the different levels of regulation also create a significant risk for retail investors to efficient asset allocation and thus to the proper functioning of the EU retail savings markets in general.

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?

As stated earlier, EFAMA welcomes the Commission’s broad approach. For us substitute products are those with similar risk features, fulfilling similar investment needs and targeting the same type of retail investor. The US SEC used to have an amusing simile: *it looks like a duck, it walks like a duck, it quacks like a duck – it’s a duck*. However, from a European perspective, currently the most serious “cases” are retail structured products, unit-linked life insurance contracts and – to a certain extent – certain banking products.

Regarding the features/functionality leading EFAMA to regard these products as interchangeable, we repeat that in many cases these products do not differ from each other regarding content and risk features; the difference lies in the legal wrapper that defines the level of transparency for the investor. This can be the case for very “simple” products such as global investment in equities or bonds (either as fund, fund of funds or under a life insurance contract) as well as in more sophisticated products such as indirect investment in hedge funds which is allowed for retail investors in many European countries under very strict disclosure requirements through funds of hedge funds. This can also take place through hedge fund certificates under far less restrictive information requirements.

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.

It is very difficult to answer this question from a European perspective as the answer depends to a large extent on the national regulatory and fiscal environment.

However, fiscal considerations are in many countries a driving factor for investment decisions and we often see that a change in taxation has an immediate and significant impact on investment decision of retail investors. Indeed, very often certain products are marketed with the focus on “tax advantages”. However, we acknowledge the point made on page 10 of the paper that there is only limited scope for the Commission to influence Member States’ tax regimes.

Regulatory treatment is insofar important that it impacts the level of information (in particular on fees) to be given to investors as well as the rules regarding conduct of business and conflicts of interest. The regulatory structure itself does not seem to be a major factor.

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.

and

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?

and

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 products? For which type of product do you see a regulatory gap in terms of the coverage of conflict of interest rules?

Questions 5, 6 and 7 should be treated together as they very much refer to the same regulation and to all three we must answer: yes, there are differences.

In a certain sense the Commission answers questions 5 and 6 already itself in pointing out that “*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*”. And the examples given in box 1 on page 15 and box 2 on page 17 speak for themselves. Also, we fully agree with the Commission that the challenge 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*”. Finally, we agree with the Commission that the IMD review scheduled to start in 2008, should be used to bring the regulation of distribution of life insurance products to a level comparable to MiFID.

To that extent, and referring to our answer to question 1, we can only repeat that pre-contractual product disclosure regarding – at least – unit-linked life insurance products and structured product is far from providing sufficient information to help investors to understand the product features (in particular regarding costs and risks) and to compare these features with those of similar UCITS. It must be ensured that – regardless of the product regulation – key information is provided to investors to help them make an informed choice, and that advice is provided on the basis of comparable levels of information.

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?

As already underlined above, there are serious regulatory gaps between UCITS and other nationally regulated investment funds on the one side and other savings products such as certificates and unit linked life insurance contracts on the other. In practice this means that savings products competing with funds are often marketed with the argument they are cheaper (while the real costs of the product for the investor are not declared) or one can save money because of tax advantages (without speaking about fees or performance) or with nearly not understandable or misleading promises which – in addition – are never controlled. From our point of view such practices are far away from fair competition.

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?

EFAMA believes that equal treatment for comparable savings/investment products targeting retail investors must be ensured by EU regulation. Our long term vision regarding the ideal regulatory architecture is well known. Similar retail savings products must be subject to comparable regulation.

However, against the background of regulatory reality in Europe, the Commission should opt for a more pragmatic approach advancing towards the ideal world whenever a relevant piece of legislation is reviewed and most urgently in the field of product transparency and distribution. In doing so, the Commission should take MiFID and the incoming UCITS KII as a benchmark for all competing savings products and strive to eliminate the regulatory patchwork.

Some efficient and relatively easy first steps in this direction could be made: regarding distribution and taking MiFID as benchmark, Article 12 IMD could be adapted to MiFID rules when the IMD is reviewed (as we understood this procedure should start this year). Regarding investor information, as said the upcoming UCITS Key Investor Information document could be taken as benchmark and Annex XII of Regulation 809/2004 (implementing the Prospectus Directive) and Annex III of Directive 2002/83/EC could be adapted accordingly.¹⁶

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?

While EFAMA is in general very much in favour of self-regulation, we must accept that the matters dealt with in the Commission’s Call for Evidence are so complex that - in our view - market forces will not solve the issues identified and cross-sector self-regulatory initiatives would need a common regulatory basis.

However, the initiative taken by the Danish National Bank in spring 2007 regarding self-regulation with respect to structured notes was rather successful as it led to far more – but still not yet perfect – transparency. But this was only possible through strong pressure by the Ministry of Finance and it took place only at national level.

We also know that certain national regulators, for example Consob in Italy¹⁷ tried to find solutions for some of the issues discussed through the implementation of the Prospectus Directive and/or the Insurance Mediation Directive. However this was

¹⁶ For more details, see our comments above to question 1

¹⁷ See : Article 94 of Legislative Decree n° 58 of 24 February 1998 (as amended by subsequent legislation. The implementation of this general rule has resulted in the achievement of a substantial uniformity in the level of details prescribed in the prospectus of insurance investment products, comparable to the UCITS prospectus. The Consob “Regolamento Emittenti n° 11971/1999 was recently modified in order to harmonise the insurance investment products’ prospectus in particular regarding the rules on its delivery and update and the information regime to investors.

done only on national level but – at the end - leads to an even more fragmented regulatory landscape.

THE CONCLUSION CAN ONLY BE A CALL FOR A REGULATORY SOLUTION AT EUROPEAN LEVEL.

Steffen Matthias, Graziella Marras, 31 January 2008