

EPFSF Briefing

“Protecting Retail Investors: More to be Done?”

Introduction

European Commission research shows that a majority of retail consumers in the EU appreciate aspects of the European Single Market in general. In one survey before the financial crisis 67% of respondents believed that competition had increased beneficially as a result of Single Market developments, while 53% thought consumer protection in the EU had become stronger.

Despite this generally positive assessment, however, direct participation by retail consumers in the Single Market in Financial Services is limited. Only 3% of consumers have ever considered buying a financial product or taking out an insurance contract in another EU country. But indirect retail participation through pooled vehicles, especially UCITS, is much higher.

Variations in the Degree and Nature of Retail Investor Protection in the EU

This direct/indirect distinction in the nature of retail participation in the EU financial services market creates distinctions in the degree and type of protection available to consumers. But it is only one of a number of kinds of difference that arise. Further variations in protection are caused by differences in the type of financial product that consumers buy. Purchases of equities, UCITS, or insurance products are all mediated by different Directives with varying degrees and kinds of consumer protection. There may be local rules in individual countries which augment the conduct of business standards set out in directives, especially MiFID, and alter the client protection achieved. Harmonised régimes for particular product categories, especially UCITS under the UCITS Directives, create a degree of uniformity but even so cross-border purchases can be subject to variations in the way Directives are nationally implemented. Most retail products are non-harmonised with commensurately greater distinctions in treatment. Finally, compensation in the event of default or market abuse may vary between member states and with the product (only bank deposits are subject to a minimum standards Directive, currently under review), cross-border enforcement may encounter legal or information sharing difficulties that place a retail consumer in another member state at a disadvantage, and the tax position may well be different between member states.

All this adds up to a highly fragmented picture of the EU's retail financial services market and the protections available to consumers. In one sense this is unsurprising: retail financial markets are notoriously localised even in territories with a single main language, a relatively homogenous financial and business culture, a single system of law and a single currency. The problem is compounded in the multi-country, multi-cultural and polyglot EU.

The Financial Crisis

While the lack of retail uptake of cross-border possibilities in EU financial services could also be said to show the scale of untapped potential, the financial crisis has brought its own difficulties to bear. Most significantly, it has highlighted that the risks faced by ordinary citizens, many of whom have suffered severe losses to pension funds and other forms of savings and investment, are unusual in the current exceptionally dangerous and volatile market conditions. In the light of their recent experiences it will require substantial effort to regain their confidence and bring them back to market. Part of achieving this must be to reassure them that their investments are secure and will not in future be exposed to excessive and irrational risk taking.

Recent Concerns about the EU Retail Financial Services Market

But another part of achieving this goal is more mundane and independent of the crisis. Work is required to ensure that consumers are confident that they will enjoy the same rights, regardless of the location in the EU of the financial institution and of the selling mode chosen. They must feel that they are being well advised with the right type and amount of information, that they are being properly protected against being misled or mis-sold products, that they can seek redress as appropriate in the event of a fraud or a bankruptcy, that they have a clear understanding of the risks inherent in a product before they buy it, and that the financial institutions with whom they are dealing are sound and safe. They must also be addressed in their own language or another in which they are highly proficient.

Work by the EP, the European Commission and others to develop the EU's retail financial market should review how far existing legislation has led us in achieving these objectives, and where there are potential gaps in legislation or implementation of existing rules. So what has been done, and what more is there to do? And how does the current crisis affect this evaluation?

The Commission's Green Paper on "Retail Financial Services in the Single Market" of 30 April 2007 briefly analysed the sector and set out certain objectives for future work:

- bringing concrete benefits for consumers notably in terms of prices, choice, and quality;
- ensuring properly regulated open markets and strong competition;
- enhancing consumer confidence by ensuring they are properly protected and that providers are financially sound and trustworthy;
- empowering consumers to make the right decisions for their financial circumstances.

Proposed approaches to achieving these goals included an improved competition framework, a reduction in differences between national regulatory, taxation and other requirements governing similar products, further reduction in market protectionism through, for example, the imposition of bureaucratic obstacles to product marketing such as unjustified "general good" rules, and ensuring that product innovation can flourish.

Regulation and Investor Protection

A swathe of regulatory means was also identified. These focused on creating an equivalent level of consumer protection throughout the EU which gives consumers the confidence to choose from a range of providers wherever they are in Europe and the ability to understand and compare products wherever they are sourced. While this has not yet been fully achieved a number of Directives have begun to lay the groundwork by establishing minimum standards in all member states.

Examples include the Consumer Credit Directive, which seeks to promote a single market in consumer credit while ensuring a high level of consumer protection, and the Directive on the distance marketing of financial services which aims to boost consumer confidence in using the internet or telephone in cross-border financial service transactions.

The Shareholders' Rights Directive¹ facilitates the exercise of voting rights by shareholders of listed companies in the cross-border European environment by setting an appropriate EU legislative framework and addressing a range of other issues including the abolition of obstacles to electronic participation in General Meetings, the right for shareholders to question and be answered by company management, and the abolition of constraints impeding the easy appointment of a proxy holder.

The industry is also playing its part, for example in the form of a significant cross-sector industry grouping that aims to set standards providing for efficient communication between shareholders and issuers. The ultimate goal is to enhance shareholder participation in general meetings, especially in the cross-border EU environment, and to avoid situations in which information does not reach the ultimate investor.

¹ [Directive 2007/36/EC](#)

This is important in identifying the ultimate owner of shares: publicity has been given to cases in which the authorities were unable to achieve this, or where the fund manager was not able to locate his/her deposited stocks. The Lehman Brothers and Madoff cases generated, unfortunately, some concerns: for example in the Madoff case it turned out to be impossible to locate the securities and identify their owners in some markets.

The generation of market confidence by consumers depends on resolving problems such as these.

MiFID

An important element of protection concerns rules designed to prevent and compensate for possible mis-selling of financial products. Quality of advice and information provided to clients are paramount to this protection.

The Markets in Financial Instruments Directive (MiFID) has introduced a harmonised comprehensive set of operating conditions applicable to both investment firms and credit institutions that regulates the relationship between them and their clients when they offer investment services. This is encapsulated in the conduct of business, best execution and client order handling rules, as well as the inducements and conflicts of interest provisions. Specific attention to retail clients is given in the MiFID's retail regime which imposes on the firm reinforced fiduciary duties and the requirement to place the client's interests first. This overall approach protects consumers by enhancing responsible behaviour towards them by regulated firms in the financial services sector.

Consumers may also be indirectly protected through professional indemnity insurance that ensures that, in the event of financial loss owing to negligent advice or other professional misconduct by insurance and investment intermediaries, damages or settlements may be claimed.

UCITS

It would be inappropriate to dwell at length on the EU's UCITS framework in this paper as it is a separate subject on its own. But UCITS are the key retail investment vehicle for millions of EU citizens, especially in cross-border business, so some summary reference should be made.

There is little doubt that UCITS has been a considerable success and the brand and underlying concepts are now used worldwide. Throughout Europe approximately €5 trillion are invested in collective investments of which about 70% are UCITS. With nearly 25 years' experience of operating the UCITS régime in the EU many of the cross-border problems have been identified and dealt with in successive development of the original Directive. The aim of UCITS, to allow specifically defined collective investments schemes to operate freely throughout the EU on the basis of a single authorisation from one member state, has not however been easy to achieve. There remain difficulties, for example in distribution and marketing, resulting from additional regulatory requirements above the Directive in individual member states. UCITS III and now UCITS IV have been addressing both these kinds of issues and the need to broaden the range of financial instruments in which a UCITS can invest. These have included money funds, derivative funds, index-tracking funds, and funds of funds. The next step in gradually opening the pan-EU market further to UCITS and as part of increasing choice but also information and transparency to consumers, is the introduction of the Key Investor Information document (replacing the simplified prospectus) throughout the EU to facilitate the marketing of UCITS and enhance consumer confidence in what they are buying.

The UCITS model has been held up as one to which to aspire in the development of pan-EU markets in nationally regulated, non-harmonised products and services. This has proved difficult to achieve without the specific product structure and other definitions that underpin the UCITS régime.

Cross-Border Redress

There are additional issues. Ensuring access to adequate cross-border redress for consumers has been problematic. The two main options of bringing a dispute to court or using out-of-court alternatives such as an ombudsman or consumer complaints board are complicated for consumers in cross-border disputes, since they need to be aware of the existence and details of foreign schemes or court procedures and there may well be language difficulties.

Legal Certainty

The provision of cross-border legal certainty for retail consumers in the EU's financial services market has also been complicated. The MiFID passporting system has helped to provide counterparty certainty in contracts with properly authorised and passported firms. But overall European regulation of the law applicable to contractual obligations is in the Rome Convention of 1980 and a subsequent Regulation. In many but not all EU member states the law applicable to a financial services contract (excluding insurance policies) is the law of the country where the consumer resides habitually provided the provider pursues commercial activities there. But in other countries it may be the law chosen by the provider (i.e. the provider's national law) as described in the standard terms and conditions. This complex situation can be daunting for consumers seeking certain legal underpinning to their transactions.

Market Confidence and Financial Institutions

The promotion of sound and safe retail financial institutions has become very important following the global financial crisis and economic recession. With a number of EU-based banks having to be rescued by national governments, customers have feared for the safety of their deposits. The value of key assets such as equities, commodities, and property has plummeted, funds of vital importance to individuals such as retirement or pension savings have diminished, and consumers have experienced a substantial loss of confidence in financial markets and institutions.

Global, regional and national work is being undertaken by public authorities including regulators to rectify matters. This activity should target issues that need addressing and should aim to shore up consumer confidence and trust in financial service providers and markets.

Independent retail financial services firms are mostly specialised organisations such as private wealth managers, agency or execution only stockbrokers, discretionary and non-discretionary portfolio managers for private clients, or financial advisors. They do not in general take deposits and the risks incurred in their business are not systemic. Many of them work closely over the long term with clients to ensure that their best interests are met. This often involves standards of client care that go beyond the requirements of the MiFID and other directives. The work of these firms helps to build and maintain retail consumer trust.

In considering the future of the retail financial services sector in the EU it will be important to recognise this role of retail providers and not to impose on them burdensome, inappropriate, and disproportionate new regulation which will increase the cost of business but not improve investor protection or strengthen retail consumer confidence in the financial markets.

Future Regulation

Much research and investigation has been conducted into the retail financial services market in the EU, including three public hearings arranged by the EC. The difficulties outlined in the Commission Green Paper persist and the market continues to be characterised by low volume activity, wide variations in prices between countries, restricted product diversity and choice, large variations in market performance, differing regulatory and tax frameworks, divergent consumer protection policies and practices, and legal and economic barriers to market entry that stifle cross-border activity and product innovation.

Untangling this web while maintaining appropriate consumer protection and confidence will take time. Relevant directives, including the MiFID, must have the chance to take effect across all EU jurisdictions. Experience of how they impact on the retail sector will be a significant factor in determining what more should be done to restore trust and improve investor protection while opening more widely the cross-border EU retail market in financial services. A Commission White Paper on this market is expected in April 2009. Further consideration to the issues should be given in the light of it, including important policy reflection on the aftermath of the crisis.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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