STUDY

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Marketing, Sale and Distribution

Mis-selling of Financial Products

Policy Department for Economic, Scientific and Quality of Life Policies
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POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Mis-selling of Financial Products: Marketing, Sale and Distribution

STUDY

Abstract

This study forms part of a series of five studies on mis-selling of financial products in the EU. The study reviews the EU legislative and regulatory framework for the marketing, sale and distribution of financial products to assess whether post-crisis EU regulatory reforms have met their objectives and, if not, what are the gaps and weaknesses in the current EU regulatory approach. The EU follows a sectoral approach to regulating the marketing and sale of financial products, which results in segmentation and arbitrage risks. The paper argues that the European Supervisory Authorities should adopt more harmonised regulatory and technical standards to reduce these risks and ensure more effective enforcement by Member State authorities. This document was provided by Policy Department A at the request of the ECON Committee.

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CONTENTS

LIST OF ABBREVIATIONS

AIFMD	Alternative Investment Fund Managers Directive
AMF	Autorité des Marchés Financiers (France)
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)
BBA	British Bankers Association
CCA	Consumer Credit Act (UK)
CSSF	Commission de Surveillance du Secteur Financier (Luxembourg)
ESMA	European Securities and Markets Authority
FCA	Financial Conduct Authority (UK)
FOS	Financial Ombudsman Service (UK)
FSA	Financial Supervisory Authority
FSAP	Financial Services Action Plan
FSMA	Financial Services and Markets Act 2000 (UK)
IBIPs	Insurance-Based Investment Products
ICBR	Intermediary Conduct of Business Rules (UK)
IDD	Insurance Distribution Directive
IMD	Insurance Mediation Directive
KID	Key Investor Document (related to the scope of PRIIPs)
KIID	Key Investor Information Document (related to the scope of UCITS IV)
KYC	Know-Your-Customer
MAR	Market Abuse Regulation
MiFID/R	Markets in Financial Instruments Directive/Regulation
MTF	Multilateral Trading Facility
OTC	Over-The-Counter
OTF	Organised Trading Facility
PPI	Payment Protection Insurance
PRIIPs	Packaged Retail and Insurance-based Investment Products
RDR	Retail Distribution Review (UK)
UCITS	Undertakings for Collective Investment of Transferable Securities
UCPD	Unfair Commercial Practices Directive

EXECUTIVE SUMMARY

The pre-crisis EU approach to regulating the marketing, sale and distribution of financial products was based on the notion that the disclosure of minimum information regarding the costs, charges and risks of financial products was adequate for retail customers to assess the expected returns and risks of different financial products. The regulatory focus on mandatory disclosure of information imposed few, if any, *ex ante* limits on the offer and design of financial products. There were largely no constraints on selling processes and on the design and distribution of financial products except for the general and ambiguous requirement that all marketing communication was '*fair, clear and not misleading*'. Under the law of most Member States, there were few, if any, legal remedies to be used against financial institutions unless it could be shown that they engaged in affirmative misrepresentations or outright fraud. Banks and other intermediaries were encouraged to know their customers to support their business strategy of selling more complex financial products and investments designed to allow their customers to benefit from the potential upside gains of liberalised financial markets but exposing them as well to the downside risks of volatile and unpredictable financial markets.

The crisis of 2007-2008 demonstrated that many retail, professional and wholesale institutional investors had failed to understand the risks associated with complex financial products and that investor reliance on mandatory regulatory disclosure was inadequate for investors to understand and assess the relevant risks. Huge losses by large numbers of customers and professional investors were attributed in part to cognitive heuristics, that is, reliance on '*rule of thumb*' approaches to deciding which products to purchase, rather than formal techniques of risk assessment. Moreover, bank and investment firm governance was too weak to address the incentives of brokers and customer advisers who were incentivised to promote '*tied*' products that paid disproportionately high commissions that were usually not disclosed to the customer.

The European Commission issued a Decision in 2011 that concluded that systematic mis-selling of financial products by financial institutions and the massive losses of institutional and retail investors could be attributed to inadequate disclosure of the underlying costs, charges and risks of products and the incentives of firms to design unsuitable products for their customers, and customers' behavioural biases and financial illiteracy. The Commission's Decision concluded that the efficacy of disclosure requirements was very much dependent on the context of the markets in which decisions were made. The result was that pre- and post-crisis, despite the adoption of extensive regulatory reforms, massive mis-selling of financial products – both to retail and sophisticated investors – was pervasive across financial markets.

This study aims to review the EU legislative and regulatory framework for the marketing, sale and distribution of financial products to assess whether post-crisis EU regulatory reforms have met their objectives and, if not, what are the gaps and weaknesses in the current EU regulatory approach. The paper will analyse the Market in Financial Instruments Directive II (MiFID II) regarding how it regulates the sale and distribution of financial products and its rules concerning conflict of interests and disclosure of costs and charges to customers. It will also assess the extent to which MiFID II provides a comprehensive regime governing the sale and distribution of financial products and the degree of segmentation risk in the market because MiFID II does not cover a wide array of other investment products, such as certain securitised investments and insurance-based investment products, governed by other EU legislation.

The paper will also consider how other EU legislation regulates the sale of financial and investment fund products, such as the Undertakings for Collective Investment in Transferrable Securities (UCITS) and the Alternative Investment Fund Management Directive

(AIFMD). The paper also considers the regulation of insurance-based investment products (IBIPs) under EU insurance legislation and the sale of endowment products that are linked to underlying financial instruments. The paper also reviews recent regulatory developments regarding the supervision of closet index funds and what risks they pose to investors.

The paper's findings are that because the EU follows a sectoral approach to regulating the sale and distribution of financial products, there are **different regulatory standards across the banking, asset management, insurance and alternative investment fund sectors governing the sale and distribution of these products** This creates segmentation risks because the risks associated with these products are subject to different legal requirements and are regulated by different sectoral regulatory bodies who apply different standards and conduct different risk assessments. For example, depending on whether a financial product is classified as a MiFID II investment or an insurance-based investment product covered by the Insurance Mediation Directive will determine what type of information has to be disclosed about the product's risks and what type of compensation can be paid to those responsible for issuing and selling the product. As a result, financial products that share substantially similar economic characteristics and risk-return features are treated significantly different in terms of disclosure requirements, conflict of interest rules in their promotion and sale, and the regulator's product intervention powers.

This paper argues that the **EU regulation of retail financial products and related investment services suffers from segmentation risks and regulatory arbitrage opportunities for financial institutions to design risky financial products that attract minimum regulatory protections**. Rather than applying similar regulatory standards to these products, the EU legislative and regulatory framework treats these products with similar risk features significantly different in terms of regulatory requirements and therefore creates an uneven regulatory playing field resulting in segmentation risks between different financial sectors in which similar risks in similar financial products are regulated differently in different financial sectors, even though these products pose the same (or similar) risks. This situation can also lead financial institutions to engage in regulatory arbitrage as the design of investments is driven mainly by regulatory compliance considerations, rather than by economic factors, such as the risk adjusted return for customers. EU draft legislation (UCITS VI) shows that progress is possible in this area. The paper suggests that EU policymakers should call for an **alignment in requirements for the marketing, sale and distribution** (along with similar product intervention powers) of all financial products sold in the EU to retail customers. This would require revising the existing EU laws governing the sale and distribution of financial and investment products across the different EU financial sectors. It would also require that the three European Supervisory Authorities (ESAs) work closely together in implementing existing and new legislation to address regulatory gaps, segmentation risks, and arbitrage opportunities. **The Joint Committee of the European Supervisory Authorities could facilitate enhanced coordination between the three ESAs to adopt more harmonised regulatory and technical standards for disclosing the costs, charges and risk metrics of all retail financial products and for adopting more harmonised remuneration rules across financial sectors for the distribution and sale of products by independent advisers.**

The paper, however, concludes that implementing a more harmonised legislative and regulatory framework governing the marketing, sale and distribution of financial products was not achieved under MiFID I and will pose serious challenges for Member State regulatory authorities under MiFID II and other EU legislation governing the sale of financial products. Segmentation risks and regulatory arbitrage will be difficult to eradicate in the financial product markets especially because of the potential for banks and other financial firms to engage in product innovation, particularly the design of different products and investments with different risk characteristics. Also, reforms to promote a more harmonised system of laws and regulations governing the sale and distribution of financial products will be difficult to address so long as the EU continues to follow a sectoral approach to regulating these products. Finally, the paper also points out **related regulatory concerns in the asset management industry concerning closet-index funds** that are charging customers for active asset management but instead are only linking their assets to the performance of index funds. The paper raises the question of whether this should be classified as a form of misrepresentation and discusses recent regulatory investigations.

Finally, the paper considers what type of institutional structure of financial regulation is appropriate for the supervision of consumer financial protection. After reviewing the main supervisory models – *Functional, Institutional, Integrated, and Twin Peaks* – **it recommends that the institutional design of financial regulation within EU Member States should require that a consumer financial protection authority should be created along the lines of the US Consumer Financial Protection Bureau and that it should be institutionally separate from the central bank or other prudential regulator responsible for prudential supervision**. At present, however, in most EU states, the prudential supervisor is typically also responsible for consumer financial protection. Member States should be required or strongly encouraged to restructure financial supervision at the Member State level so that the consumer financial protection agency is institutionally independent from the bank regulator.

This paper has also considered and reviewed the European Commission's draft proposals for a '*New Deal for Consumers*' package that was proposed in April 2018 just after this paper was finalised. The Commission's draft legislation is relevant to retail financial services regulation in the EU because it would create a new collective redress regime where EU consumer law, including MiFID II, UCITS, PRIPS and IDD, has been violated. The Commission's proposals include a new draft Directive on representative actions for the protection of the collective interests of consumers in which '*qualified entities*' would be authorised to bring a representative action before a Member State court or administrative authority on behalf of classes of consumers who have suffered losses for a trader's violation of EU consumer protections laws. If the trader is found liable, it would be required to compensate the consumers who suffered losses or take other redress measures to make them whole again. Redress for retail customers of banking or financial institutions would be available where the bank or financial services firm was shown to have breached prescribed EU financial services legislation. This paper's welcomes the Commission's draft Directive because it would provide financial consumers with an additional procedural avenue to have their rights asserted under EU financial services law and to compensate them for losses and to provide any other adequate relief. The paper concludes however that such legislation will not be effective unless it is accompanied by substantive reform of EU financial services legislation (MiFID II, UCITS, PRIPs and IDD) to reduce segmentation risks and regulatory arbitrage between the different pieces of EU financial consumer legislation and to ensure that an independent regulatory authority to act on behalf of consumers (including to bring claims on their behalf) is created in each Member State. Such an independent regulatory authority could potentially work with the qualified entities proposed in the Commission's draft Directive. For the Commission's draft Directive on representative actions to succeed and become an effective mechanism for financial consumers to vindicate their rights under EU law, it must be accompanied by legal and regulatory reform on other fronts as discussed in this paper.

1. PRE-CRISIS EU REGULATORY APPROACH TO FINANCIAL PRODUCTS

KEY FINDINGS

The crisis of 2007-2008 demonstrated that many retail, professional and wholesale institutional investors had failed to understand the risks associated with complex financial products and that investor reliance on mandatory regulatory disclosure was inadequate for investors to understand and assess the relevant risks. Moreover, bank and investment firm governance was weak and did not address the incentives of brokers and customer advisers who were incentivised to promote excessively risky products that were unsuitable for their clients. Despite the adoption of extensive regulatory reforms following the crisis, massive mis-selling episodes continued to occur in many EU Member States. Although the post-crisis regulatory reforms addressed some of the risks associated with persistent mis-selling, significant weaknesses in the EU regulatory regime remain due to gaps in implementation, supervision and enforcement, resulting in different levels of investor protection across the EU, thereby increasing market segmentation.

1.1. Information Disclosure Paradigm

Prior to the crisis, investors were deemed to be *'well-informed*', rational, and wealth maximising. The rational investor was a customer of a bank, investment firm, or insurance firm who was **empowered by the information that was disclosed** by financial intermediaries and issuers to make efficient and wealth maximising investments. Most consumer or retail financial regulation was based on the assumptions of neo-liberal classical theory that held that investors are rational agents who seek to maximise their wealth by allocating their investments according to their risk appetites to obtain the highest risk-adjusted return[1]. Based on this assumption of the rational wealth maximising investor, policymakers designed a model of retail or consumer financial regulation that was based on more and relevant information disclosure for investors to make their own rational calculations and assessments of risk to fit their unique circumstance. The regulator would only intervene in cases of significant consumer injury[2]. Despite widespread dissemination of information to the customers of financial institutions, there were many instances of systematic and intentional mis-selling of financial products and related investment services by institutions and their brokers in the 1990s and 2000s. Systematic and widespread mis-selling continued post crisis despite the adoption of extensive international and EU regulatory reforms.

Systematic and widespread mis-selling led policymakers and regulators across the EU and in third countries to adopt alternative theories of regulation that are based on behavioural finance models that emphasise the bounded rationality or capability barriers of investors. These models hold that the rationality of investors is bounded because of the complexity and inherent asymmetric information barriers in financial markets and that investors often do not

[1] Kingsford Smith and Dixon, p. 707. Similarly, in competition regulation, the notion of a rational and informed consumer who maximises its utility by seeking the lowest most competitively priced product dominates the assumptions of policymakers and jurists.

[2] According to the traditional law and economics approach, investors can determine their product of preference if provided with information on the price, quality and other factors of products. The availability of information creates an incentive for sellers to improve their products, leading to competition, consumer welfare and an efficient economy. See Beales et al, 1981, p.492. Accordingly, the US Federal Trade Commission stated: "It is a basic tenet of our economic system that information in the hands of consumers facilitates rational purchase decisions." See FTC, 1979.

act rationally in their best interests and are subject to irrational behaviour, such as herding, that can lead to more volatile and lower investment returns over time[3].

Other regulators have emphasised the importance of financial literacy, defined as '*financial awareness, knowledge, skills, attitude and behaviours necessary to make sound financial decisions*'[4]. Studies suggest that **financial literacy is very low among most retail financial customers**. Recent mis-selling scandals demonstrated that many retail, professional and institutional investors had failed to understand the risks associated with complex financial products and that investor reliance on mandatory regulatory disclosure was inadequate for investors to understand and assess the relevant risks. Substantial losses incurred by large numbers of customers and professional investors were attributed in part to cognitive heuristics, that is, reliance on **'*rule of thumb*'** approaches to deciding which products to purchase, **rather than formal techniques of risk assessment**. Behavioural bias, including overconfidence, risk tolerance, social influence, framing effects (highlighting positive features, downplaying potential losses) proved to influence significantly the investments and financial products subscribed to by many bank customers and investors.

The European Commission recognised these market failings in a 2011 Commission Staff Working Paper that attributed the systematic mis-selling of financial products by financial institutions and the massive losses of institutional and retail investors to market failures connected with inadequate disclosures of the costs, charges and risks associated with financial products, and the incentives within firms to design unsuitable products[5]. *Chater et al.'s* Final Report to the European Commission on Consumer Decision-Making in Retail Investment Services stated that retail investors in the EU struggled to make optimal investment decisions; that they were influenced by behavioural weaknesses, and the efficacy of disclosure requirements was very much dependent on the context of the markets in which decisions were made[6]. Other market failures identified by the report included retail customer confusion, very limited searching for information, difficulties in processing conflict of interest disclosure, heavy reliance on trust in investment advice[7]. The result was that pre- and post-crisis, despite the adoption of extensive regulatory reforms, massive mis-selling of financial products- both to retail and sophisticated investors – was endemic to the markets.

The pre-crisis EU approach to regulating the marketing of financial products was based primarily on a disclosure framework that imposed few, if any, *ex ante* limits on the offer and design of investment products. Moreover, there were largely no constraints on selling processes and how products were distributed. Banks and other intermediaries were encouraged to know their customers to support their business strategy of selling more and innovative financial products designed to allow their customers exposure to the potential gains of liberalised financial markets while allowing them to assess and manage the risks for themselves.

1.2. Pre-Crisis EU Regulatory Framework

A fundamental assumption of EU policymakers was that the **disclosure** of more and relevant information to investors and customers would lead to a more efficient and socially optimal market. Indeed, the EU Council Decision at Lisbon in June 1999 to adopt the Financial Services Action Plan (FSAP) consisted of over forty pieces of legislation to make European financial markets more competitive and innovative in order to compete globally, particularly with the US capital markets. The FSAP was premised on the notion that the main role of

[3] See Shiller, 2000, pp. 14-17.
[4] OECD, 2011, p. 3.
[5] European Commission, Impact Assessment, 2011.
[6] Chater et al., ch. V.
[7] Chater et al., ch. I.

regulation in financial markets was to protect investors and consumers by disclosing more information and that regulatory intervention can only be justified when it is cost-effective and a least restrictive option to protect consumers.

The FSAP legislative agenda included the Prospectus Directive 2003 and Prospectus Regulation 2004. More significantly, for this paper, was the adoption in 2004 of the Markets in Financial Instruments Directive I (MiFID I 2004/39/EC). Member States were required to transpose and implement MiFID I by 2007. MiFID I contained the overarching principle of best execution and applied to investment services and trading venues, including official exchanges and multilateral trading facilities (MTFs). MiFID was regarded as a milestone in the EU's regulation of financial markets. MiFID I set out specific provisions for harmonising the regulation of investment services across the EU and guaranteeing a minimum level of investor and financial consumer protection. MiFID I also contained the important objective of protecting the customers of banks and other financial firms in the purchase of certain financial products. For example, Article 19(2) MiFID I required that information addressed to clients, including marketing communications, should be fair, clear and not misleading[8].

Regarding the distribution of financial products, banks and other financial intermediaries were required to disclose the risks to clients, but there was no obligation for firms to advise clients. Investors were expected to assume the risks based on information and guidance provided. Furthermore, it was relatively straightforward for a bank or other firm to reclassify customers as professional clients who were not subject to heightened disclosure of risks or to any type of duty of care from the selling institution. Although MiFID I addressed conduct of business concerns in the sale of financial products (including marketing, disclosure, and suitability requirements), there were **inadequate controls regarding conflict of interests, product design, and order execution.** Moreover, the widespread and pervasive nature of mis-selling of financial products in most EU states following MiFID I's implementation deadline of January 2007 suggests that most Member States and some firms failed to implement it adequately into domestic law and regulation[9]. For instance, a 2011 Study on the implementation of MiFID I found that firms gathered insufficient information on clients' backgrounds and abilities to invest, that firms focused more on the amount of the potential investment rather than on due diligence, and that investment advice provided was largely based on superficial information[10].

Also, the Directive regulating collective investment schemes known as Undertakings for Collective Investment in Transferrable Securities (UCITS III)[11] contained principles and rules for the regulation of asset management firms and other firms providing collective investments in transferrable securities. UCITS III consisted of two Directives: Directive 2001/108/EC that increased the scope of UCITS to a much broader number of instruments, and Directive 2001/107/EC that provided minimum standards, which a UCITS asset management company should comply with in terms of capital and risk control, rules of conduct and conditions relating to technical and human resources.

Following the adoption of most of the FSAP legislative agenda, the Commission issued a White Paper in 2005 (Financial Services Policy Agenda 2005-2010) that stressed the need for a period of '*dynamic consolidation*' and a legislative pause and stock-taking. During this period,

8 Article 27 (2-8) of the MiFID I Implementation Directive (Commission Directive 2006/73/EC of 10 August 2006), defines the requirements for marketing communications with respect to the obligation under article 19 (2) of MiFID I.

9 See discussion below of massive mis-selling of financial products by UK banks between 2008 and 2013, and Kupšys, 2017, discussing Lithuanian courts upholding bank sales practices that arguably violated MiFID I requirements that marketing communications are '*fair, clear and not misleading*.' See article 19(2) MiFID I.

10 See Moloney, 2015, p.747, fn 59.

11 UCITS III consists of two directives: EU Directive 2001/108/EC of 21 January 2002, EU Directive 2001/107/EC of 21 January 2002.

the gaps and weaknesses of the FSAP sectoral approach to regulation that relied primarily on a disclosure paradigm for investor and retail customer regulation were becoming more apparent as episodes of mis-selling were growing more common across the EU.

The impact of the global financial crisis of 2008 further exposed the tenuous fault lines in the EU FSAP regulatory approach. **Serious financial market risks for retail financial clients were caused in part by financial institutions engaging in regulatory arbitrage due to the sectoral approach to regulation.** Institutions could repackage products so that they could be subject to less strict regulatory standards. Different rules applied to functionally similar products. For example, UCITS III – but not MiFID - required financial intermediaries (investment management firms) to provide a market summary disclosure for retail investors. For MiFID and UCITS and other legislation such as the Insurance Mediation Directive I (IMD I), there were very limited powers for product intervention, and ambiguities and gaps in EU legislation allowed Member State regulators to engage in light-touch regulation along with passive supervision that allowed financial firms to avoid investor safeguards. Despite the reforms brought about by MiFID I and IMD I, the crisis demonstrated weaknesses in EU regulation of financial product distribution and the disclosure of risks[12]. The crisis and its aftermath resulted in massive losses for retail customers and investors that were exacerbated by systematic mis-selling practices that understated the risks for retail investors but were very profitable for the institutions, which sold them[13].

Persistent mis-selling was also demonstrated during the transition from MiFID I to MiFID II. Indeed, some of the more egregious mis-selling practices in the sale of structured and proprietary products and of complex interest rate hedging products were designed to rebuild financial institutions' balance sheets by generating more profits during the post-crisis economic slowdown and to offset some of the costs associated with compliance with prudential regulatory requirements, such as the Capital Requirements Directive IV[14].

In the UK, structured products that were guaranteed by the US investment bank Lehman Brothers were sold based on **significant advice failures** and **serious disclosure deficiencies**. The UK Financial Services Authority (FSA) brought numerous enforcement actions[15]; and the German regulator Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) brought actions against banks and investment firms in relation to the marketing and sale of Lehman debt certificates[16]. Across other EU Member States, regulators brought many mis-selling actions and complaints were filed with Ombudsmen services, and alternative dispute resolution methods were used in some EU Member States to address major mis-selling problems that were exacerbated because of substantial losses that materialised during the crisis[17].

In addition, regulatory weaknesses were associated with mis-selling. The vulnerability of the investment product distribution market to market failures derived from the **dominance of complex packaged products** as retail investments; the persistent conflict of interest risk arising from the '*financial supermarket*' model or **commission-based adviser business**

[12] See cases filed in 2015 against the Luminor bank (the successor bank of the Nordic DNB Bank) for the mis-sale of index-linked bonds in 2007-2008 (before and after MiFID I came into effect) by the DNB Bank, which had loaned its customers the funds to purchase products that were marketed as '*low risk*' and '*guaranteed*', but which turned out to be highly risky. As a result of the bank's customers purchasing these highly risky bonds, they incurred substantial losses wiping out most of their principal investment (over 100 million litas, about 30 million euros). The claims against the Luminor bank (then DNB Bank) are pending in the Lithuanian courts, while the issues of whether the bank's sales practices were in violation of MiFID I and the Market Abuse Directive have been referred to the Court of Justice of the European Union (CJEU). See Kupšys (2017), p. 1.

[13] Moloney, 2014, p. 786.

[14] Moloney, 2014, p. 787.

[15] See discussion in section 1.3.

[16] Herbert Smith, p. 3.

[17] European Commission, Impact Assessment, pp. 3-5.

model; proliferation of complex products; incomplete disclosure and the limited ability of investors to understand complex products[18].

MiFID I's process-based quality-of-advice rules struggled to ensure that customers had adequate information and were offered suitable products. Also, regulatory arbitrage was a problem, as MiFID I principles and rules did **not apply to insurance-based investment products or deposit-based investment products**. Financial firm governance was too weak to address the incentives of brokers and customer advisers who were incentivised to promote '*tied*' products that paid disproportionately high commissions or '*retrocessions*' that were usually not disclosed to the customer and were designed to generate related revenue streams to increase profits for financial institutions following their huge losses during the crisis[19]. Arbitrage also arose from segmentation and classification of investors and products[20]. The financial crisis revealed the great risks for customers – regardless of whether they were wholesale or retail investors - without adequate market experience who were allowed to invest in complex financial products by accessing the products on the wholesale market.

1.3. UK mis-selling

The United Kingdom provides an exceptional case study of how an EU Member State can implement the requirements of EU financial legislation, such as MiFID I, into its domestic law and regulatory framework, yet still suffer from a massive and widespread mis-selling crisis instigated largely because of weak governance practices in financial firms, light touch supervisory practices and inadequate enforcement action by the regulator. Customer complaints for mis-selling against UK banks and financial services firms received much attention during the pre- and post-crisis periods, especially following the British banking crisis of 2007–08.

Under English common law, all banks that sell financial products and services to clients and customers are generally subject to a **duty of care** in the sale of these products and services. The duty of care, however, is subject to limitations imposed by the principle of freedom of contract, which allows the parties in the contractual agreement to dispense with the duty of care, resulting in a *caveat emptor* (buyer beware) relationship between the bank and its customer. The buyer beware relationship however does not negate the bank's duty of care not carelessly to misstate facts – which means that the bank's affirmative representations or statements cannot be inaccurate or false without attracting potential liability. Nevertheless, a bank's duty of care to advise its clients of the risks or on the suitability of a product '*should not be readily inferred in a commercial relationship*'[21]. Depending on the financial product or investment sold, the duty of care could entail a duty to investigate the suitability of the products sold to customers and, if appropriate, a duty to warn customers of the risks of investing in these products. English courts, however, have overwhelmingly ruled against bank customers who have claimed that their banks owed them a duty of care to assess their suitability for the sale of certain financial products when the parties have agreed in writing to dispense with the duty of care. Under English law, when the parties dispense with the duty of care, it is almost impossible for the customer to prevail on a mis-selling claim absent some showing of fraud or affirmative misrepresentation.

Similarly, the UK statutory and financial regulatory regime has also struggled to provide adequate avenues of redress in cases involving vulnerable retail customers – including individuals and small businesses – who were mis-sold financial products. After having failed to supervise the sales practices of regulated financial institutions (especially banks) in the

[18] Moloney,2014, p. 788.

[19] Moloney, 2014, p. 788.

[20] Moloney,2014, p. 791.

[21] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] at 531, per Mance J.

early 2000s, which resulted in massive mis-selling of financial products to individual and small business customers, the former Financial Services Authority (FSA) and the Financial Conduct Authority (FCA, established in 2013) both played a more active role in encouraging customers and financial institutions to allow the **Financial Ombudsman Service (FOS) to settle disputes** between institutions and retail clients and small business customers[22].

The Ombudsman regime has been extensively utilised to file millions of claims against banks for mis-selling financial products, including payment protection insurance (PPI) and derivative products such as interest rate swaps. Since the early 2000s, borrowers who purchased PPI to insure against the risk that they may be unable to maintain loan repayments have sought redress for mis-selling through the FOS and the courts. The courts have clarified the law on PPI mis-selling in several decisions assessing the lawfulness of PPI mis-selling regulations[23] and on the unfair relationship between lenders and borrowers.

The case of *Harrison & Harrison v Black Horse Limited*[24] involved the legal question of whether a lender's failure to disclose the existence or amount of commission from an insurer on their sale of PPI to a customer amounts to unfairness in the relationship between the parties pursuant to section 140A of the Consumer Credit Act 1974 (CCA). Both the High Court and Court of Appeal decided the claim against the borrower claimants and their appeal to the Supreme Court was subsequently withdrawn by consent.

The borrowers had also claimed that an unfair relationship was created by the lender's[25] breach of the regulator's intermediary conduct of business rules (ICOB rules) and the PPI policy was unsuitable owing to the length of the cover and its cost[26]. The facts of the case involved two loans obtained by the borrowers from the lender, both taken out with PPI. The second loan was then discharged by refinance in 2009 and the PPI was cancelled. The PPI was sold by the lender to the borrower as agent for the actual insurer, Lloyds TSB General Insurance Limited; therefore, it was an insurance intermediary acting on an advise basis in relation to the specific PPI offered. The lender earned 87% of the premium in commission from the insurer on the sale of the PPI, which was not disclosed to the borrowers. This decision has **raised the bar of proof** even higher for borrowers seeking compensation in the courts for alleged PPI mis-selling – in particular, it cannot be argued that a lender's failure to disclose their commission created an unfair relationship under section 140A of the CCA.

Alternatively, borrowers can seek redress through the FOS which applies a **fairness test** based on the UK regulator's treating customers fairly principle to decide cases. The use of the Ombudsman has tended to result in more favourable outcomes for borrowers than pursuing actions in court[27]. As a result, the vast bulk of mis-selling claims against British banks has been brought before the Ombudsman based on the regulatory law principle of treating customers fairly, rather than asserting a breach of contract or tort law claim in court. The British Bankers Association challenged in court the regulator's use of the Financial Ombudsman Service, rather than the courts, for binding resolution of mis-selling complaints as beyond the regulator's powers under law. However, the English High Court issued a

[22] The Financial Services Markets Act 2000 established the Financial Ombudsman Service (FOS) that provides a scheme to allow customer complaints to be adjudicated against financial services firms in cases involving general insurance, banking and credit, and investment services. See Financial Services and Markets Act 2000. Consumer credit later came under its remit on 6 April 2007 based on the Consumer Credit Act 2006. Consumer Credit Act 2006 c.14.

[23] *R (on application of the British Bankers Association) v Financial Services Authority and Financial Ombudsman Service* [2011].

[24] *Harrison & Harrison v Black Horse Limited* [2011].

[25] The lender was part of the Lloyds TSB Group.

[26] The applicability of the ICOB rules to the bank's duty of care in the sale of PPI and other regulated financial products to commercial and individual customers has been reaffirmed in *Saville v Central Capital Ltd* [2014].

[27] Financial Ombudsman Service (UK) has stated: '*What we consider to be fair and reasonable redress will depend on the individual circumstances of the complaint*'.

judgment in 2011 rejecting the BBA legal challenge and upholding the regulator's powers to use the Ombudsman service to provide legally binding resolution of mis-selling complaints[28]. The Ombudsman Service is much easier and less expensive for claimants to bring mis-selling claims compared to the courts, and will likely become the main avenue for redress by claimants.

In summary, following the mis-selling scandals, the UK regulatory authorities have utilised the Ombudsman Service to resolve mis-selling complaints against banks with legally binding effect. This has had the effect of **expanding the scope of the bank's potential liability for mis-selling**[29]. As discussed above, the most prominent application of UK regulatory rules to banks mis-selling of financial products came in respect of the sale of payment protection insurance (PPI). The UK regulator adopted regulatory guidelines and a policy statement on PPI complaints handling that reflects a stricter approach to ensuring that bank customers have an adequate remedy to resolve their mis-selling claims before the Financial Ombudsman, which should serve as a precedent for customers in bringing future claims.

1.4. Pre-crisis EU regulatory reforms shortcomings

MiFID I, UCITS and other pre-crisis EU legislation did not prevent another wave of large-scale mis-selling scandals that occurred just before and after the financial crisis[30]. For instance, the UK attempted to address this by proposing in 2007 the Retail Distribution Review (RDR), which came into force in 2013, that sought to address the regulatory weaknesses for the marketing and sale of financial products. The RDR contained a ban on commission in distribution of packaged investment products, imposed strict labelling requirements on whether advice is independent or restricted, and stringent qualification rules for investment advisers[31]. The UK reforms, however, did not address other types of commission-based compensation and incentive problems caused by conflicts of interest. Similarly, across Europe, weaknesses in the regulation of incentives for '*tied*' agents in the sale of financial products resulted in pervasive mis-selling by European financial institutions and investment firms of structured and other complex and risky products (i.e. interest rate hedging products) pre-crisis to individuals and small businesses which continued post-crisis in many EU countries, such as Spain, Slovenia and the UK[32].

MiFID I concerns arose particularly regarding advice for the **sale of unsuitable products and the impact of complex products on investors who did not fully appreciate the risk**[33]. *Moloney* observed that although MiFID I addressed the distribution of financial instruments, not much success was achieved in preventing mis-selling during and after the crisis[34]. Although MiFID I applied to the sale of many products sold by banks and securities firms, it did not apply to many other financial instruments and products governed by other directives. For instance, it did not apply to unit-linked investments, distribution of which is subject to the Insurance Mediation Directive (less detailed than MiFID I although it contained some protections which MiFID I did not)[35].

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[28] *R (on application of the British Bankers Association) v Financial Services Authority and Financial Ombudsman Service* (per Ouseley J) [1999].

[29] UK Financial Supervisory Authority Policy Statement, p. 1.

[30] Moloney 2015, p. 759.

[31] Moloney, 2015, p. 759.

[32] The mis-selling of Bankia preferred shares Spain in 2009, subordinated bonds in Slovenia in 2013-2014 and the current discussion on the mis-selling relating to the British Steel Pension Scheme. See Better Finance, 2017, Financial Times, 15 February 2018.

[33] European Commission, Review of MiFID.

[34] Moloney, 2014, p. 805.

[35] Moloney, 2010b, p. 336.

Moreover, *Colaert* asserts that, after entry into force of MiFID I, mutual funds were often repackaged as life insurance products or as structured deposits to avoid the MiFID regime (regulatory arbitrage)[36]. Thus, Member States requested a wider scope of MiFID conduct of business rules to expand MiFID I coverage to include certain insurance products and/or structured deposits, while some Member States, such as the UK and France, largely duplicated MiFID-like rules into their domestic insurance law[37].

The Commission's Staff Working Paper of the Impact Assessment accompanying the MiFID II and MiFIR proposals identified major concerns and uncertainties about the way certain services are delivered to investors, such as the scope of execution-only services, the quality of investment advice, or the framework for inducements. For the latter, the MiFID rules for disclosure on incentives from third parties have not always proven to be very clear or well-articulated for investors. The mis-selling cases have created issues regarding the provision of services to non-retail clients and the classification of clients as either professional or retail. However, the lack of data on execution quality could impair the ability of investment firms to select the best possible venue for executing a trade for a client.

1.5. Crisis results in further changes to MiFID

The crisis demonstrated that regulatory **disclosures were insufficient** to solve information asymmetries and conflicts of interest, nor to address the risks associated with the volume and complexity of information. This showed the need to move away from primary reliance on the information disclosure paradigm that enshrines the notion of the empowered investor and confident consumer to a new philosophy of '*consumer protection*' and the need to '*treat customers fairly*'. This new focus on suitability and treating customers fairly implies that regulators should occasionally intervene in the market and adjust or ban certain products. Indeed, the **need for product intervention** in response to complex products, acknowledges the limits of disclosure and financial literacy in addressing market failures.

[36] Colaert, 2017b, p. 591; European Commission, 2008, p. 11, stating that in France, sales of unit-linked life insurance increased following the implementation of MiFID.

[37] Colaert, 2017a, p.18.

2. POST-CRISIS REGULATORY APPROACH - MIFID II/ MIFIR

KEY FINDINGS

The Markets in Financial Instruments Directive/Regulation (MiFID II/MIFIR) was the most significant EU legislation to reform the marketing, sale and distribution of financial products. MiFID II focuses on three main areas: **distribution**, **disclosure**, and **product intervention**, and has wide application to all financial institutions and infrastructure including banks, investment firms, fund managers, exchanges and other trading venues, high frequency traders, brokers and pension funds and retail investors. Regarding financial products, its requirements apply to designated MiFID financial instruments and products that relate to equities, fixed income, commodities and foreign exchange. Although MiFID II covers a wide range of financial instruments, it does not comprehensively address distribution of insurance-based products (governed by the Insurance Distribution Directive) and depository-based investments. Also, the MiFID II inducement regime does not include a ban on commissions across all sales channels, but only applies the ban to independent advisers. It raises the question of whether commission or tied products should be prohibited or restricted across all sales channels. Because MiFID II does not apply to other financial instruments regulated by insurance supervisors or covered by other EU legislation, it raises the **concern of segmentation risks and regulatory arbitrage**.

2.1. A Change in Focus

The post-crisis regulation reforms for the marketing and sale of financial products and related investment services focus on three main areas: **distribution, disclosure, and product intervention**. Under these legislative and regulatory reforms, a different precautionary *ex ante* approach is taken to retail markets and product distribution[38]. This approach adopts a different rationale for the regulation of the sale and distribution of financial products, which moves away from the disclosure paradigm to a behavioural finance paradigm. As mentioned in Chapter 1 above, pre-crisis the regulation of the sale of retail financial products and investment services was based on a disclosure paradigm that assumed that investors can rationally assess information that is disclosed to them and then based on this and other information widely available in the market decide which financial products to invest in order to maximise their individual utilities and achieve the greatest risk-adjusted returns. In contrast, the **behavioural paradigm** suggests that bank clients and investors are not able to process all the relevant information and to calculate the risks, and that regulation should be designed to play a more interventionist role to limit, for example, the potential downside losses of risks for customers and to take account of behavioural biases that arise from social and biological factors[39].

2.2. MiFID II/MiFIR

MiFID II has the stated objective of making European financial markets safer, fairer and more transparent and to restore investor confidence after the financial crisis. Following the regulatory reforms which took place worldwide after the 2007–08 financial crisis, the European Commission attempted to address gaps and weaknesses in MiFID I by replacing it with Directive 2014/65/EU (MiFID II) and adopting Regulation No 600/2014 (MiFIR)[40] to furthermore close the gaps created between MiFID II and EMIR (Regulation (EU) 648/2012).

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[38] Moloney, 2014, p. 789.

[39] See Shiller, 2000, p. 27. See also Coates and Herbert, 2008, p. 6169.

[40] Directive 2014/65/EU (Markets in Financial Instruments Directive/ MiFID II), Regulation (EU) No 600/2014 (Markets in Financial Instruments Regulation/ MiFIR).

The European Commission has issued a number of delegated acts further specifying the rules under MiFID II[41] and MiFIR[42]. MiFID II was required to be transposed into Member State law by July 2017 and, together with MIFIR, became legally enforceable on 3 January 2018[43]. The Commission launched 19 infringement actions in October 2017 against Member States who had failed to transpose the legislation by the deadline[44].

MiFID II applies to all financial institutions and infrastructure including banks, investment firms, fund managers, exchanges and other trading venues, high frequency traders, brokers and pension funds and retail investors. It widens the scope of application of provisions including conduct of business rules to cover a broad range of markets including equities, fixed income, commodities and foreign exchange, and products, including futures, exchange traded products, retail derivatives such as contracts for differences and structured deposits (Article 1(4) MiFID II)[45]. MiFID II aims to require most trading to take place on regulated markets, including exchanges, Multilateral Trading Facilities (MTFs), Organised Trading Facilities (OTFs) and Systematic Internalisers. MiFID II empowers regulators to require more transparency for off-exchange markets and volume caps for equity '*dark pools*'. Banks and other financial intermediaries are required to unbundle client payments for analyst research and trading commissions, and provide stricter standards for investment products.

The **unbundling of client payments** for analyst research and trading commissions is likely to affect how financial products are sold and how investment advice is rendered. Indeed, it is an important part of the MiFID II regime that regulates how asset managers pay for the research they use to make investment decisions. It was a major concern to what regulators saw as a conflict of interest at the heart of trading that hurts asset managers' clients including pension funds, ordinary savers and retail investors because banks that were acting as brokers for asset managers were able to pass along the cost of research to the asset managers who would then pass the costs on to their clients without disclosure. Basically, pre-MiFID II, asset managers received research, including written reports and phone calls with analysts, for free from banks and other financial firms, although the cost of this service was built into trading fees, which are usually paid by fund managers' clients. For the first time, fund managers will have to budget separately for research and trading costs, otherwise known as unbundling.

The unbundling and organisational requirements are expected to have an impact beyond the EU. The EU demands for the personal details of traders are already creating tensions with the privacy rules of other jurisdictions outside the EU, such as Hong Kong and Singapore. The new regime on research payments also poses a significant challenge for US brokers. Under US regulations, brokers cannot receive direct payments for research unless they are formally registered as investment advisers. This means, in theory, that they will not be able to provide research to European clients — who will be obliged to make direct payments for this service — from 2018, unless they are registered with the US Investment Advisers Act 1940. The Securities and Exchange Commission (SEC), the US regulator, has the power, however, to waive the rules and allow brokers to receive direct payments for research from

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[41] Commission Delegated Regulation of 25.04.2016 supplementing Directive 2014/65/EU; Commission Delegated Directive of 07.04.2016 supplementing Directive 2014/65/EU.

[42] Commission Delegated Regulation of 18.05.2016 supplementing Regulation (EU) No 600/2014; 'Overview and state of play of RTS and ITS relating to MiFID/MiFIR'. The Commission has adopted more than 30 delegated Regulations for MiFID II and MiFIR, with 28 of them are commonly referred to as '*RTS*'. The full list of the delegated regulations can be found for MiFIR at: https://ec.europa.eu/info/law/markets-financial-instruments-mifir-regulation-eu-no-600-2014 and for MiFID II at: https://ec.europa.eu/info/law/markets-financial-instruments-mifid-ii-directive-2014-65-eu_en.

[43] Regulation (EU) 2016/1033; Regulation (EU) No 596/2014; Directive (EU) 2016/1034.

[44] See European Commission Press Release (2017) http://europa.eu/rapid/press-release_MEMO-18-349_en.htm As of 20 February 2018, 10 Member States still have not fully implemented MiFID II and Commission Delegated Directive (EU) 2017/593.

[45] Annex I, Section C MiFID II lists all financial instruments covered by MiFID II.

investors who are subject to MiFID II. The SEC is expected to make a decision in 2018 or 2019; but in the meantime US banks and other institutions which employ these brokers will come under pressure to comply with the MiFID II rules and if they do so they will agree to register with the SEC as investment advisers in order to be able to continue servicing clients with EU operations.

MiFID II also addresses the selling processes of financial institutions by adopting rules governing their organisational requirements and conduct of business provisions. As to the organisational requirements of banks, reference is made to the new provisions on product governance arrangements relating to banks which develop financial products and to those which sell them[46]. The purpose of such provisions is to enhance the banks' understanding of the products they develop or sell and to ensure that they are suitable to the clients to whom they are being sold[47]. To this end, **investment firms are required to maintain, operate and review the process for approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients**[48]. Moreover, specific record-keeping provisions have been laid down in the context of the organisational requirements. In particular, records shall include the recording of telephone conversations or electronic communications relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders. Banks or investment firms must also notify new and existing clients that telephone communications or conversations between the firm and its clients that result, or may result, in transactions will be recorded[49].

Sales targets and remuneration rules are also applicable to banks and other covered financial intermediaries. These rules are based on the European Securities and Markets Authority's (ESMA) Guidelines on Remuneration Policies and Practices and aim at ensuring that staff incentives do not result in conflict of interests or impinge upon the firm's obligation to act in the best interest of the client[50]. Finally, as to conduct of business, Articles 25 and 27 of MiFID II narrow the list of execution-only products and widen the list of information banks or investment firms have to provide with regard to best execution[51].

The MiFID II/MiFIR closed the exception for non-advice execution-only financial products, including for structured UCITS product that are marketed to retail customers and makes it more difficult for a retail client to be opted-up to professional client status. MiFID II creates high level requirements on the distribution of insurance-based investment products. It prohibits firms from offering lending (margin) services in conjunction with execution-only services. It creates a new category of '*independent investment advice*', in which advice labelled as independent must advise clients on a cross-market selection of financial instruments. There is also a prohibition on commission payments for independent advice and a prohibition on commission payments for discretionary asset management.

MiFID II now contains a **stronger principle of fair treatment** that includes a fiduciary-style obligation on the investment firm to act fairly in the client's best interests (Art 24(1) MiFID II), and a duty to act honestly, fairly, and professionally in accordance with the best interests of firm's clients. This is known more generally as a duty of loyalty that is designed to address the weaknesses with the previous information disclosure regime that did not take account of the disadvantages confronting clients who often suffer from asymmetric

[46] See Busch, 2017, p.124.

[47] MiFID II, Art 16.

[48] MiFID II, Art 16(3).

[49] MiFID II, Art 16(6) and (7). It should also be mentioned that to ensure that record keeping occurs properly, the investment firms must even synchronise their clocks with clocks at the exchanges.

[50] MiFID II, Art 24(10).

[51] MiFID II, Arts 25 and 27.

information problems and behaviour biases[52]. Also, regarding marketing, Article 24(3) requires that all information addressed by a firm to clients to be '*fair, clear and not misleading*'[53].

MiFID II now regulates the **quality of advice** rendered to clients by requiring financial advisers to undergo training and have minimum education in finance and related fields before they can be authorised as agents who can advise clients. This involves demonstrating that the products they sell their clients are suitable: the suitability assessment must be based on a '*know your customer*' (KYC) assessment. Advisers are required to state whether the advice is provided on an independent basis or not.

Regarding a firm's execution-only regime, there are more prescriptive rules regarding when clients can be treated only for trade execution purposes, and there are limitations regarding which products can be sold on an execution basis only. However, MiFID does not apply these restrictions to a number of other structured investment products that can be sold by asset management firms under the UCITS directive on an execution-only basis.

Regarding product intervention, MiFID II/MiFIR confers on ESMA and Member State regulators in consultation with **ESMA the power to prohibit** or restrict the marketing, distribution, or sale of a particular financial instrument or type of activity. MiFID II also makes a stricter distinction between eligible counterparties[54], professional and retail investors, and the ability of retail clients to opt-up to the professional client classification, which provides fewer safeguards for the client.

Compared to MiFID I, MiFID II aims to enhance the level of protection of different categories of clients. However, there will be room for further analysis once the implementation process is completed in accordance with the Commission's ongoing level 2 rule-making process and the final level 3 compliance and enforcement stage. Before the Brexit referendum, the UK competent authorities were considering the necessary changes for transposing MiFID II into domestic legislation[55]. In particular, they were assessing the impact that the new EU legislation may have on the ability of UK credit institutions and investment firms to contract out of their duty of care to retail and wholesale customers and to limit their liability to both consumer and commercial customers[56].

2.3. MiFID II Shortcomings

The reform of the provision of independent advice was an attempt to resolve the conflict of interest problem, but the reforms are apparently having limited effect, as they **target only independent investment advice** and therefore will affect only a very small segment of EU product distribution market. MiFID II also **seems to lack specific requirements for strict supervision of organisational governance requirements** to prevent conflict of interests in the design and sale of financial instruments and products.

Moreover, MiFID II has been criticised for not going far enough in regulating the marketing or promotion of financial products. As with MiFID I, MiFID II contains a requirement that marketing materials are required to be '*fair, clear and not misleading*'[57]. However, MiFID II goes further with additional requirements regarding the distribution of research and

[52] Moloney, 2014, p. 800.

[53] See Enriques and Gargantini, 2017.

[54] '[E]ligible counterparties' have the least protection under MiFID II and impose the fewest duties on the investment firms.

[55] The Financial Services and Markets Act 2000 (Qualifying EU Provisions) (Amendment) Order 2016. This Order applies some amendments to the Financial Services and Markets Act 2000 (Qualifying EU Provisions) Order 2013. The purpose of these amendments is twofold: (1) to make MiFIR a qualifying EU provision for various parts of FSMA; and (2) to ensure that the FCA and PRA have the appropriate powers to perform their roles under MiFIR.

[56] HM Treasury, 2010, pp. 15-16.

[57] Art. 24(3) MiFID II.

marketing materials in Articles 36 and 37 of Commission Delegated Regulation 2017/565. Furthermore, MiFID II cross-references the Market Abuse Regulation (MAR) by requiring MAR principles to be adhered to regarding what information goes into marketing and research documents.

Although MiFID II covers a wide range of financial instruments, it does **not comprehensively address distribution of insurance-based products** (governed by the Insurance Distribution Directive (IDD)).[58] However, MiFID II has made targeted reforms to the distribution of insurance-based products by imposing additional conflict of interest and disclosure-related obligations on the direct sales and distribution and advice of insurance-based investment products. MiFID II provides high-level requirements for the distribution of insurance-based products by insurance companies; but the IDD remains a lighter touch regime that imposes less strict standards regarding how advice is rendered by insurance firms and also allows for commissions and inducements for the sale of insurance-based products[59].

MiFID II also contains incomplete disclosure requirements on the distribution of financial instruments and products covered by the Directive. For instance, it does not address standardisation or format, or how retail-oriented summary disclosures should be designed. Moreover, the regulation of financial products is a new and untested tool for the EU and may have unexpected effects. Particularly the power to impose product bans may lead to an intrusive and heavy-handed regulatory approach. It places a great deal of authority with the regulator to find the optimum levels of risk and choice in the retail market[60]. Nevertheless, the new regulatory framework has merits in seeking to impose controls on the distribution of extremely risky financial products to retail customers whose principal value can be lost.

Other weaknesses with MiFID II include the concern that although it aims to protect clients it does not accomplish this because of the lack of standardised information disclosed to customers and the lack of any consistent format to present information on costs, charges and risks between different financial services providers[61]. As a result, industry bodies have attempted to fill the gap by encouraging member firms to prepare a European MiFID Template (EMT) that attempts to provide standardised information for customers, but this is not compulsory. However, this does not seem to work, as a recent study by the UK investment adviser SCM Direct found that of 10 large fund management groups with total assets of GBP 387 billion, only 40% disclosed MiFID II costs and charges on their website using EMT[62].

Moreover, regarding advice, MiFID II does **not differentiate between client groups with different levels of financial literacy**[63]. Effective advice requires different advice for different client groups with different investment objectives. Also, it is argued that MiFID II uses too many rules and instruments to achieve identical goals, thereby generating excessive compliance costs. This would potentially drive banks out of some segments of the retail business. Also, the MiFID II inducement regime does not include a ban on commissions across all sales channels, but only applies the ban to independent advisers. It raises the question of whether commission or tied products should be prohibited or restricted across all sales channels.

58 See Colaert, 2017 b.

59 Moloney, 2014, p. 778.

60 Moloney, 2014, p. 834.

61 Franke, Mosk, Schnebel, 2016, p. 1. PRIIPS, in contrast, requires disclosure of standardised document for costs and charges.

62 SCM Direct, 2018.

63 However, MiFID II does provide different levels of protection between retail investors (highest protection), professional clients (mid-level protection, and eligible counterparties (low to no protection).

MiFID II requires extensive disclosure of the risks associated with financial products and the compensation arrangements around the distribution of such products. These disclosure requirements have been criticised because they may lead to **long complex disclosures for customers, which is especially challenging for retail clients**[64]. Such complex and extensive disclosures may be benefitting the firm more than the customer. Also, it is not clear whether MiFID II restrictions on investment products sold execution-only may enhance investor protection[65].

Finally, MiFID II's restriction on conflicts of interest, especially concerning the disclosure and inducement rules, only applies to the sale of MiFID-scope instruments. This has created the incentive to promote products not subject to regulatory controls under MiFID, thereby leading to the possibility of firms arbitraging the marketing and sale of unit-linked investments, insurance-based and deposit-based investments[66]. Investors confronted with Packaged Retail and Insurance-based Investment Products (PRIIPs) (Regulation (EU) No 1286/2014) may assume that similar regulatory protections apply to other products as well. Member States have the discretion to require stricter standards and requirements than what the MiFID II regime requires. For example, the UK Retail Distribution Review resulted in the extension of the MiFID II regime to other structured and insurance-based products. The UK super-equivalence approach could also be utilised by other Member States who would like to apply the MiFID II controls to other non-MiFID II instruments.

64 See Conradi, 2018, p. 39, discussing report of SCM Capital showing that most UK investment service firms do not provide standardised information on costs, charges and risks for different investment products, nor are they comparable between different investment firms.

65 UK House of Lords, 2015, p. 50.

66 Moloney, 2010 b, p. 337.

3. OTHER EU LEGISLATION: UCITS IV/V, AIFMD, IDD

KEY FINDINGS

As with MiFID II, other EU legislative reforms regulating the marketing and sale of financial products are now focusing on the **quality of disclosure** and **simplification of information disclosed**. UCITS IV and UCITS V provide a model for this occurring in the fund management industry by requiring asset management firms to disclose a standardised '*Key Investor Information Document*' (KIID) to all investors before a contract can be concluded with an investor. Nevertheless, the crisis revealed that there are gaps in the prudential regulation of UCITS fund management firms and the need for enhanced operational risk controls for depositaries as well.

3.1. UCITS IV (2009/65/EC) and UCITS V (2014/91/EU)

UCITS IV focuses on the regulation of product design for investors who are sold units or shares in collective investment schemes. A key feature of product design is the *'Key Investor Information Document'* (KIID)[67]. The KIID is designed to provide investors with important information in non-technical language. Related to the KIID, investors are entitled to receive a prospectus that details the underlying assets and explains the related risks. An asset management or investment firm regulated under UCITS IV can mitigate its exposure to civil liability in the sale of a UCITS investment product by providing the investor with a KIID. Civil liability for the sale of UCITS investment products can only arise if the KIID is misleading, inaccurate or inconsistent with the relevant parts of the prospectus.

Also, UCITS IV removed barriers to improve investor disclosure and adopt more detailed standards for conduct of business in the design of funds, but did not address wider issues and systemic and operational risks that emerged during the crisis[68]. It also aims to address the need to increase investor protection and improve investor confidence by enhancing rules on responsibilities of depositaries, introducing remuneration policies, and increasing related regulatory and supervisory powers. It also seeks to bring rules on depositaries and remuneration in line with AIFMD[69].

The European Commission engaged in a future framework for investment funds (Consultation paper, 2012[70]) that raised important issues that were addressed in the revision of UCITS and the adoption of UCITS V. UCITS V specifies the vital functions of depositaries and sets forth prudential controls on their operations. It also addresses investment firm remuneration policies and practices, and sets forth standards and requirements to enhance investor protection, such as liquidity requirements for money market funds and internal controls to improve risk governance. Moreover, it discusses efficient portfolio management techniques, long-term investment culture and the suitability of investment products.

3.2. UCITS VI?

The Commission consultation paper in 2012 addressed UCITS product rules, liquidity management, depositary money market funds and long-term investments[71]. It reviewed the types of eligible assets for a UCITS fund. It addresses regulatory concerns such as the appropriateness of application of highly sophisticated investment strategies for a UCITS

[67] The UCITS KIID should not be confused with the Key Information Document ('KID') required under the Packaged Retail Investment Insurance Directive (PRIIPS) (discussed below).

[68] Norton Rose Fulbright, pp. 2-3.

[69] Norton Rose Fulbright, pp. 2-3.

[70] European Commission, Consultation on UCITS.

[71] European Commission, Consultation on UCITS.

product; current common practice to gain exposure to non-eligible assets through financial derivatives instruments linked to indices, closed-ended funds or structured transferable securities. It also analyses the liquidity rules for eligible assets and exposure to non-eligible instruments by adopting a look-through approach or diversification rules at the underlying asset level[72].

Commentators have emphasized the need for a UCITS VI to have **enhanced standards for efficient portfolio risk management**, especially regarding how fund managers manage their lending exposures in the short-term lending and repurchase (repo) agreement market. A revised UCITS should require more risk management standards for fund managers and require them to test the effectiveness of portfolio management techniques, especially in respect to liquidity risks. There should be more specific criteria for the eligibility of assets in a UCITS fund and for the types of collateral that can be held for short-term securities lending transactions and mandatory haircuts for collateral during periods of market turbulence. Regulators should work with managers on diversifying their asset exposures and the type of collateral they hold for short-term lending and repo markets and for the re-use of collateral in other types of transactions.

Regarding the types of assets held in a UCITS fund, practitioners have noted the need to have more clarity on the use of over-the-counter derivatives (OTC) in a UCITS fund. The Commission consultation paper also considers the introduction of a **European passport for depositary banks** and on measures to foster long-term investments for retail investors[73].

Moloney[74] has raised the issue of segmentation risk that arises from certain investment products that are covered by MiFID product distribution requirements which are not also applicable to UCITS products or other insurance-based investment products. Specifically, the 2009 UCITS IV Directive does not address the distribution of UCITS units by UCITS or its managers, although it requires that all marketing communications must be fair, clear and not misleading and consistent with prospectus disclosures (UCITS IV, Article 77). As UCITS investments are not covered assets under MiFID, they are not subject to the distribution rules, remuneration restrictions, and product intervention powers of MiFID. As such, it becomes clear that different coverage and purposes of the regulatory instruments create gaps and overlapping application that undermines consistency in application. For instance, the limited scope of MiFID II to certain financial products excludes certain UCITS products whose design and distribution would not be subject to the same safeguards against conflicts of interest.

3.3. AIFMD (2011/61/EU)

The Alternative Investment Fund Managers Directive (AIFMD) aims to create a harmonised European regime for alternative investment funds (such as hedge funds, real estate and private equity) and their managers[75]. The number, size and riskiness of alternative investment funds are many and they pose different levels of risk to their investors and to society. Regulations governing alternative asset managers were subject only to minimum disclosure standards pre-crisis. The AIFMD is designed to **increase transparency of risk exposures so that regulators can monitor** leverage exposures and other risks that could threaten financial stability and undermine investor protection. Article 17 of AIFMD requires minimum levels of due diligence, transparency and risk retention for fund managers for their investments in securitisation positions. AIFMD essentially provides for an extension of the disclosure and prudential requirements of the UCITS regime to include all non-UCITS fund

72 Deloitte, 2014, p. 2.
73 Deloitte, 2014.
74 Moloney, 2014, p. 336.
75 Ernst & Young, 2015, p. 2.

managers, including private equity, property and commodity fund managers. On the other hand, there is concern that AIFMD allows fund managers to sell very risky products to professional investors, which would otherwise not be permitted under MiFID II.

A major criticism of the AIFMD framework is that it has **very wide scope** of coverage and market participants are critical that its '*one size fits all*' regulatory approach fails to address adequately the different levels of risk that alternative investment funds pose. The disclosure requirements and risk management controls are fairly extensive and arguably impose disproportionate costs on certain segments of the asset management sector. The regulations are also criticised as putting at risk the competitiveness of the EU asset management industry. It also creates a disincentive for third country funds and their managers to seek access to EU markets, thereby restricting investor choice and overall asset and funding diversification[76].

In 2017, the EU adopted Regulation (2017/2402/EU) (known as the 'S*ecuritisation Regulation*'), that applies to securitisation transactions by requiring the originators, sponsors and lenders to be directly obliged to meet the prudential requirements of the Regulation, rather than (as is currently the case under AIFMD, 2011/61/EU) requiring the alternative investment fund manager, as the investor, to be responsible that the originators, sponsors and lenders have complied. This results in the repeal of Article 17 AIFMD. However, AIFMD has a new provision stating that where AIFMs are exposed to securitisation positions, which do not meet the requirements of the Securitisation Regulation, the AIFM shall take corrective action.

3.4. General gaps of the current framework

The EU legal and regulatory framework governing the marketing, sale and distribution of financial products **fosters segmentation of requirements and risk management practices across different financial product classes**. This segmentation of regulatory requirements creates unnecessary inefficiency in the markets. For instance, certain products that are covered by MiFID II but not by the Insurance Mediation Directive will face different conduct of business risks and will have different requirements regarding remuneration, including the payment of bonuses, and risk management. This will influence business models and the types of products offered. It may also lead to an uneven regulatory playing field and contribute to arbitrage and lower standards in the sale and distribution of products, thus potentially leading to biased advice, poor product-selection, and inappropriate advice to switch products.

The current EU legislative framework governing the marketing, sale and distribution of financial products and related investment services attempts to address key mis-selling and distribution risks. However, the different legislative and regulatory requirements for financial products and investments in different financial sectors have created a silo-based regulatory system that encourages regulatory arbitrage and results overall in poor investor outcomes. Financial institutions and other product providers have **incentives to design products, which respond to arbitrage possibilities rather than to investor needs**[77]. Moreover, the disclosure requirements across MiFID II, UCITS V and AIFMD are fragmented. For retail investors, it is extremely complex and difficult to recognise the different levels of protection attached to functionally similar products, but which are governed by different legal and regulatory requirements.

[76] UK House of Lords, 2015, pp. 1-2.

[77] Moloney, 2010 a, p. 185.

4. THE AGENCY DESIGN OF FINANCIAL REGULATION

KEY FINDINGS

This section considers what type of institutional structure is appropriate for the supervision of consumer financial protection. After reviewing the main supervisory models – *functional, institutional, integrated, and twin peaks* – it recommends that the institutional design of financial regulation within EU Member States should be based on the principle that **consumer financial protection cannot be discharged efficiently and effectively if it is conducted within the same agency as banking supervision.** The rationale for this is similar to that where the competition authority is separated from the financial stability agency because, on occasion, their objectives may conflict. In the United States, the Dodd-Frank Act 2010 created an independent Consumer Financial Protection Bureau (CFPB) with enforcement powers whose governance and decision-making authority is separate from the agencies responsible for banking supervision. However, in most EU Member States, the prudential supervisor is typically also responsible for consumer financial protection. The section concludes that the CFPB model should be followed by Member States, but this model would probably be legally unsound at the EU level because of the constitutional doctrine of conferred powers and Article 5 of the Lisbon Treaty containing the principle of subsidiarity.

The institutional design of financial regulation has historically differed between states and jurisdictions. Generally, four main supervisory models of financial regulation provide the canvas on which states develop their institutional structures of financial regulation and supervision. These models are known as the ***'functional*, *institutional*, *integrated*, and *twin peaks'*** approaches[78]. According to the '*functional*' approach, supervisors are responsible for the type of financial business or function of a firm or institution. Different supervisors would have responsibility for different lines of financial business.

In contrast, the '*institutional*' model of supervision attributes competences or powers to a regulatory body depending on the type of financial institution subject to supervision. The legal classification of the institution, for instance, whether it is defined as a bank or credit institution, investment or securities firm, or insurance company, determines which regulator has competence to supervise it. Where the institution is authorised to engage in a number of different financial activities, the regulator is empowered to supervise all these activities.

The *integrated* approach generally involves a regulator with full or consolidated authority to supervise all financial institutions and approved individuals in the financial sector regarding their discharge of all functions in the financial services industry. The integrated model was popular in the 1990s with many countries (i.e. UK, Korea, Japan and Germany) adopting it because of the perceived synergies that a single regulator would have in supervising financial markets that were becoming increasingly integrated and liberalised[79].

The *twin peaks* approach involves the division of supervisory powers between (usually) two regulators: one with responsibility for financial stability including prudential supervision of financial institutions, and the other responsible for conduct of business and investor and consumer protection in the marketing and sale of securities and other financial products. The twin peaks approach has become increasingly used by countries post-crisis because the financial crisis demonstrated the importance of having one regulatory authority solely devoted to financial stability and another regulator with responsibility for investor and

[78] See Ferran, 2015, pp.99-128. See also Group of Thirty, 2008.

[79] Briault, 1999.

consumer protection in light of the scandals involving mis-selling of investments and financial products[80]. And in some countries, the twin peaks approach has taken a new dimension as regulators are given some responsibility for ensuring competition in the financial services industry.

Although some states have adopted a version of one of the above models in practice, most states have experimented with hybrid institutional forms that are the product of historical evolution and the design of constitutional structures (i.e. federalism) and the design of economic and financial institutions[81]. States are continuing to experiment with different institutional structures of supervision post-crisis as they did prior to the crisis. No one size appears to be optimal for all countries, as financial, legal and political systems vary between states.

The European Union embarked on a major institutional restructuring of financial regulation by creating a European System of Financial Supervision (ESFS) consisting of three micro-prudential supervisory authorities – the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational and Pension Authority – and a European Systemic Risk Board (ESRB) to conduct macro-prudential oversight of the European financial system[82].

Although the sectoral approach to financial regulation may be appropriate for the European Supervisory Authorities, it is not necessarily the most appropriate approach at the level of Member States. The crisis has taught us that the supervisors responsible for prudential oversight and financial stability should be independent – and institutionally separate – from the supervisors responsible for investor and consumer protection. This is because the objectives of financial stability and investor or consumer protection can diverge and in some cases may conflict. Accordingly, in the European Union, a fundamental principle should be adopted at the Member State level that **the consumer protection agency should be separated from the supervisory agency in charge of financial stability.** This principle is justified for the same reasons that in most Member States the competition authority should stand separate from the financial stability agency because, on occasion, their objectives may conflict. In the United States, the Dodd-Frank Act of 2010 created an independent Consumer Financial Protection Bureau (CFPB) with enforcement powers while in the UK the new Financial Conduct Authority (FCA) also has consumer protection in its remit. However, in most EU Member States, the prudential supervisor is typically also responsible for consumer protection. This report recommends that the EU encouraged Member States to create an independent agency along the lines of the US CFPB with independent enforcement powers. Because of the EU Treaty doctrine of conferred powers and the principle of subsidiarity, it is most appropriate legally not to create an EU agency with strong enforcement powers to bring legal actions representing aggrieved financial consumers. This power should be exercised at the Member State level.

[80] Taylor, 1995; and Taylor, 2009.

[81] Ferran, 2015, 100.

[82] Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board OJ L 331. See Green and Jennings-Mares (2014), p. 3. https://media2.mofo.com/documents/140106-regulatory-reform-in-europe.pdf.

5. ENDOWMENT INSURANCE PRODUCTS

KEY FINDINGS

Insurance-based investment products (IBIPs) expose retail investors to the risk of capital loss subject to market fluctuations. However, they are regulated as insurance products because their value is linked to capital life insurance, unit-linked life insurance and hybrid products. IBIPs generally are **not subject to MiFID II** regulatory controls on product regulation, conflicts of interests and remuneration. Instead, IBIPs have been subject to lighter touch regulation under the Insurance Mediation Directive which contains only minimum restrictions on the design and distribution of products and minimal restrictions on remuneration.

The EU approach to regulating the marketing and distribution of financial products is piecemeal and lacks common concepts and terminology. MiFID II should perhaps have covered also insurance-based investment products (generally considered to be substitutes to certain financial instruments).

The EU **sectoral approach** to regulating differently functionally equivalent investment products with similar economic characteristics **should be reconsidered**, as different regulatory approaches for these products lead to segmentation risk and regulatory arbitrage.

Insurance-based investment products (IBIPs) are also known as endowment insurance products. The Packaged Retail Investment Insurance Products (PRIIPs) Regulation introduced the technical term IBIPs to insurance law. The PRIIPs Regulation requires that the sale of such products be accompanied by a Key Information Document (KID) that describes the risks and is not misleading[83]. IBIPs expose retail investors to the risk of capital loss (directly or indirectly) subject to market fluctuations. However, they are also often linked to capital life insurance, unit-linked life insurance and hybrid products. This type of investment product acknowledges that life insurance contracts cover biometric risks and frequently contain an investment component (with risks and opportunities) intended to offer value to policyholders both in the event of death and survival.

The PRIIPs Regulation defines IBIPs as insurance products which offer *'a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations*'. IBIPs generally are not subject to MiFID II regulatory controls on product regulation, conflicts of interests and remuneration. Instead, IBIPs have been subject to lighter touch **regulation under the Insurance Mediation Directive (IMD)**, which contains only minimum restrictions on the design and distribution of products and minimal restrictions on remuneration. The IMD will be replaced by the Insurance Distribution Directive (IDD) in October 2018.

Under both PRIIPs and the IDD, there is an obligation for the issuer of IBIPs to produce a KID and additional requirements for distribution stipulated in the IDD Implementing Act that covers advice and sales. MiFID II and the IDD have similar principles for the regulation of product design and distribution, such as the general duty to act honestly, fairly, and professionally in accordance with the customer's best interests (Article 17(1) IDD reflecting Article 24(1) MiFID II). Although they contain similar principles, there are significant

[83] See Commission Delegated Regulation (EU) 2017/653. The Commission's Delegated Regulation for PRIIPS requires that the KID is limited to three pages and must contain a description of 1) purpose, 2) the product, 3) what are the risks and expected returns, 4) what if the underlying PRIIPS issue is unable to pay out to the investor, 5) What are the costs, 6) How long must the investor hold the product before selling it and 7) complaints procedure.

differences between MiFID II and IDD. There are **higher protections under MiFID II**. For instance, IDD has no separate conduct of business rule on product governance (equivalent to Article 24(2) MiFID II). Also, MiFID II and IDD have different conduct of business rules for inducements, independent advice, and investor protection.

Regarding inducements[84], MiFID II prohibits all inducements with limited exceptions, whereas the IDD permits insurance intermediaries/undertakings to receive inducements so long as it is part of '*fulfilling their obligations*' to their customers and if not detrimental to the quality of service and duties to act honestly, fairly, and professionally in the customer's best interests. The IDD provides minimum harmonisation in this area while Member States are allowed to have stricter '*super-equivalent*' provisions along the lines of the UK Retail Distribution Review.

Regarding '*independent advice*'[85], MiFID II has strict rules regarding disclosure to the customer about whether the adviser is providing independent advice. Moreover, the provision of independent advice must involve advice on a wide variety of products, and also comply with the inducements regime (Article 24(7) MiFID II). In contrast, the IDD has minimum harmonisation rules on the provision of independent advice and Member States are not required to restrict inducements (i.e., bonuses) for the provision of independent advice.

Moreover, for investor protection, MiFID II has a much stricter distinction between retail and professional investors and limits the ability of the firm to upgrade a retail investor to professional investor status unless certain assessments are completed regarding investor's suitability to be treated as a professional investor. In contrast, the IDD has no such distinction between retail and professional investor. This is a significant difference in treatment regarding the sale and distribution of MiFID II products and IBIP products governed under the IDD.

This sectoral approach to regulating investment products that have similar characteristics and investment functions is highly questionable and should be reconsidered by policymakers. This hampers creation of a true level playing field for all investment products. Also, supervision is sectorally divided (MiFID: ESMA /IDD: EIOPA) between two of the European Supervisory Authorities.

In addition, there are gaps in the EU legislative and regulatory regime. The EU regulatory approach is piecemeal and **lacks common concepts and terminology**. MiFID II should perhaps have covered also IBIPs (generally considered to be substitutes to certain financial instruments and structured deposits which are subject to MiFID II's conduct of business rules). These differences can lead to **segmentation risk and to regulatory arbitrage**.

[84] Colaert, 2017 b, p.596.
[85] Colaert, 2017 b, p.597.

6. CLOSET INDEXING

ESMA defines '*closet indexing*' as a '*practice of fund managers claiming to manage portfolios actively when in reality the fund stays close to a benchmark*'[86]. This essentially involves fund managers charging their clients for actively managing their investments when in fact all they are doing is '*hugging*' an index ('*index-hugging'*). ESMA believes that index-hugging harms investors as they are '*not receiving the service or risk-return benefits they expect based on the fund's disclosure documents while potentially paying higher fees compared to those typically charged for passive management*'[87]. The German regulator BaFin has stated that this practice could be a problem of providing '*false or misleading information*'[88].

ESMA published on 2 February 2016 a Statement of its work on closet index tracking funds and its research on the topic. It studied 2 600 funds for the period 2012-2014. It observed based on investor disclosure documents that between 5 % and 15 % of UCITS equity funds could potentially be closet indexers[89]. It also found that on average **nearly 30 % of gross fund return went to ongoing fees, one-off charges and inflation**[90].

6.1. Investigations of Closet Trackers

Several national competent authorities have conducted investigations of closet indexing. The German BaFin states that they did not detect any cases but they nonetheless call for more transparency[91]. Luxembourg's Commission de Surveillance du Secteur Financier CSSF stated in 2017 that no UCITS domiciled fund in Luxembourg was identified as engaging in closet indexing, with the exception of one case of closet indexing under investigation[92]. The French Autorité des Marchés Financiers (AMF) stated that French-domiciled funds were reviewed and based on the ESMA analysis were not closet tracker funds[93]. And the UK Financial Conduct Authority (FCA) undertook a review in 2017 of 84 potential closet tracker funds and in 2018 demanded changes from 64 of those funds, in which the fund managers were required to make it clearer to consumers that they were very '*constrained*' in actively managing their customers' investments because they were tracking or '*hugging*' an index, rather than actively managing their customers' funds. These funds were also required to pay GBP 34 million in compensation to investors because they were charging them for active management while in reality they were following a constrained decision-making approach that mainly involved tracking an index[94]. For example, the FCA found that seven key investor information documents (KIIDs) lacked clear descriptions of how funds were managed; five of which '*used a benchmark-related approach that should have been disclosed*'[95].

The consumer advocacy group Better Finance in February 2017 replicated the above mentioned ESMA study and found that up to 165 equity UCITS funds to be potential closet indexers[96]. ESMA estimates that about 33 % of potential closet indexers do not disclose their benchmark's performance alongside their own performance in their KIID, and that this does not comply with UCITS IV. As a result, ESMA calls for more transparency on reasons for

86 ESMA.
87 ESMA.
88 BaFin, news.
89 ESMA, 2016, p. 3.
90 Jones, 2017, p. 4.
91 BaFin, 2016, p. 3.
92 Jaminon.
93 Paredes-Vanheule.
94 Butler, 2018.
95 FT Advisor, 2016, p. 1.
96 Better Finance used the same database (Morningstar as ESMA). See Better Finance, 2017.

charging *'active*' fees, and for more transparency on the part of ESMA and NCAs regarding fund's metrics and for further monitoring and investigations[97].

Better Finance also compiled a list of asset managers, which have potentially sold closet index funds, including Henderson, Fidelity, JP Morgan and Schroders. This demonstrates that **improvements can be made**. For instance, investor disclosure on the use of benchmarks (e.g. in KIID and prospectus). ESMA announced it will complete a study of fees and past performance of mutual funds by late 2018[98] and that it would publish guidance in 2019 on *'stress testing*' of mutual and alternative investment funds to check if they can withstand severe market shocks[99].

97 Statement of Guillaume Prache, Managing Director of Better Finance: '*These findings are clear proof that EU regulators must not eliminate the standardised disclosure of the long-term and relative past performance of retail investment products to their benchmark, as they unfortunately plan to do in the implementing rules for Priips.'* FT Adviser.

98 Jones, 2017.

99 Jones, 2017.

7. CONCLUSION

This paper argues that the **EU regulation** of retail financial products and related investment services **suffers from segmentation risks and regulatory arbitrage opportunities for financial institutions to design risky financial products that attract minimum regulatory protections**. Rather than applying similar regulatory standards to these products, the EU legislative and regulatory framework treats these products with similar risk features significantly different in terms of regulatory requirements and therefore creates an uneven regulatory playing field resulting in segmentation risks between different financial sectors. This situation can also lead financial institutions to engage in regulatory arbitrage as the design of investments is driven mainly by regulatory compliance considerations, rather than by economic factors, such as the risk adjusted return for customers. EU draft legislation (UCITS VI) shows that progress is possible in this area. The paper suggests that EU policymakers should **call for an alignment in requirements for the marketing, sale and distribution** (along with similar product intervention powers) of all financial products sold in the EU to retail customers. This would require **revising the existing EU laws** governing the sale and distribution of financial and investment products across the different EU financial sectors. It would also require that the three **European Supervisory Authorities work closely together** in implementing existing and new legislation to address regulatory gaps, segmentation risks, and arbitrage opportunities. One way to enhance ESA coordination in this area would be to involve the Joint Committee of the European Supervisory Authorities, consisting of representatives of the three ESAs, to facilitate the adoption of regulatory technical standards and technical guidance for Member States to apply in their regular supervision.

The paper, however, concludes that implementing a more harmonised legislative and regulatory framework governing the marketing, sale and distribution of financial products will be challenging. Addressing segmentation risks and regulatory arbitrage will be difficult to eradicate in the financial product markets especially because of the potential for financial institutions to design different products that fall outside regulatory parameters, particularly regarding their risk characteristics. Also, reforms to promote a more harmonised system of laws and regulations governing the sale and distribution of financial products will be difficult to address so long as the EU continues to follow a sectoral approach to regulating these products. Finally, the paper also points out related regulatory concerns in the asset management industry concerning **closet-index funds** that are charging customers for active asset management but instead are only linking their assets to the performance of index funds. The paper raises the question of whether this should be classified as a form of misrepresentation and discusses recent regulatory investigations and suggests that **further supervisory attention** to this issue should be given.

The report also recommends that the institutional design of financial regulation in EU Member States should be based on the principle that **the consumer financial protection agency should be separate institutionally from the supervisory agency in charge of prudential supervision or financial stability.** The rationale for this is similar to that in most Member States where the competition authority is separated from the financial stability agency because, on occasion, their objectives may conflict. In the United States, the Dodd-Frank Act of 2010 created an independent Consumer Financial Protection Bureau with enforcement powers whose governance and decision-making authority is separate from the agencies responsible for banking supervision. However, in most EU Member States, the prudential supervisor is typically also responsible for consumer financial protection. The report suggests that the agency responsible for consumer financial protection should be a standalone agency whose tasks could be coordinated or integrated with the competition authority.

As an epilogue, this paper has considered the European Commission's draft proposals for a '*New Deal for Consumers'* package that was proposed in April 2018 just after this paper was finalised. Specifically, the Commission's draft Directive on representative actions for the protection of the collective interests of consumers was reviewed in which '*qualified entities*' would be authorised to bring a representative action before a Member State court or administrative authority on behalf of classes of consumers who have suffered losses for a trader's violation of EU consumer protections laws. Redress for retail customers of banking or financial institutions would be available where the bank or financial services firm was shown to have breached prescribed EU financial services legislation. This paper welcomes the Commission's draft Directive because it would provide additional procedural avenues for retail financial customers to assert their rights against financial institutions which have breached EU financial law and to obtain compensation or other adequate redress. However, the paper concludes that such legislation would not be effective unless accompanied by wider ranging reforms of EU financial services law to reduce the segmentation risks and regulatory arbitrage opportunities discussed in this paper. Also, qualified entities will be ineffective in asserting claims on behalf of retail financial customers if they do not have an independent and proactive consumer financial protection institution to work with at the Member State level. For the Commission's draft Directive on representative actions to be effective, it must be accompanied by legal and regulatory reforms as discussed elsewhere in this paper.

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This study forms part of a series of five studies on mis-selling of financial products in the EU. The study reviews the EU legislative and regulatory framework for the marketing, sale and distribution of financial products to assess whether post-crisis EU regulatory reforms have met their objectives and, if not, what are the gaps and weaknesses in the current EU regulatory approach. The EU follows a sectoral approach to regulating the marketing and sale of financial products, which results in segmentation and arbitrage risks. The paper argues that the European Supervisory Authorities should adopt more harmonised regulatory and technical standards to reduce these risks and ensure more effective enforcement by Member State authorities. This document was provided by Policy Department A at the request of the ECON Committee.

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