LEGAL CONSIDERATIONS REGARDING THE INTRODUCTION OF PACKAGED RETAIL INVESTMENT PRODUCTS UNDER FINANCIAL MARKET TRANSPARENCY CONTEXT

CONSIDERAŢII LEGALE PRIVIND INTRODUCEREA PRODUSELOR INVESTIŢIONALE DE RETAIL ÎN CONTEXTUL TRANSPARENŢEI PIEŢEI FINANCIARE

MARIANA BĂDOI[1], DIANA BRÎNZĂ[2]

[1]Affiliation: Private Pension System Supervisory Commission, Romania
maria.badoi@yahoo.com
[2]Affiliation: University of Piteşti, Romania

Abstract: *In all European countries, investment funds or units in undertakings for collective investments are addressed by national law, which distinguishes them from other financial products or assets. The objective of this paper is to establish whether there is a real and significant – as opposed to perceived or theoretical – risk to investor protection resulting from the different levels of product disclosure or intermediary regulation embodied in EU financial services legislation.*

Key words: *Prips, investment funds, unit-linked, structured products, UCITS.*

INTRODUCTION

As a starting point, this paper asks which investment products should be taken into consideration. Under European Commission, a PRIP is a product where the amount payable to the investor is exposed to fluctuations in the market value of assets or payouts from assets, through a combination or wrapping of those assets, or other mechanisms than a direct holding. The market for PRIPs is characterised by an enormous variety of products and providers – all competing for the savings of retail clients. A healthy and competitive market for PRIPs has a key role to play in the recovery of Europe's economies from the financial crisis. European Commission considers a need for better protection measures for retail investors who buy packaged investment products (such as retail investment funds, insurance-

based investment products, retail structured securities and structured term deposits). Products to be classified as a PRIP should have an element of packaging, be capable of meeting an investor need for capital accumulation and create exposure to investment risk.

As a second point, this paper identifies four possible areas for investigation: product disclosures, conflict of interest management by product originators and intermediaries, point of sale rules to be respected by intermediaries to limit the sale of unsuitable products, and rules on advertising.

MATERIALS AND METHODS

A retail saver with the economic objective of saving money for the relatively long term and maximizing the potential return, can be offered a tailored solution ranging from investment funds to unit-linked life insurance products, annuities, term deposits, structured products or others by the same distributor. In a context where individuals and households are assuming greater responsibility for retirement provisioning and long-term financial planning, values invested through retail investment funds, unit-linked life insurance products and retail structured products amount to more than €10 trillion. Net sales are close to € 500 billion a year.

(a) Investment funds

Economic description. Investment funds are a form of collective investment vehicle that invests the pooled funds of a large number of investors for a fee. Funds raise money by selling shares of the fund to the public/investors. In return, shareholders receive an equity position in the fund.

Customer segment. Investment funds may be UCITS or nationally regulated funds. UCITS are designed for retail investors although around 25% of assets under management are distributed to institutional investors. They are increasingly distributed on a pan-European basis through the UCITS passport. Nationally regulated funds may be authorized, provided certain national rules are met, for distribution to retail investors.

Economic objectives. Investment funds, notably UCITS intend: a) to yield a superior return than a traditional bank deposit by investing in specific investments; b) to give investors access to a wider range of

securities than the investors themselves would have been able to access; c) to assure redemption on demand and d) to reduce trading costs by gaining economies of scale in operations.

Investment features and restrictions. To protect retail investors, in addition to rules relating to fund diversification, liquidity and use of leverage, the UCITS Directive imposes strict rules on the investment policy of funds. The discretion of the fund manager is legally restricted so that investors do not have to rely on the skills and the due diligence of the fund manager alone.

Legal approaches. In all Member States, investment funds or units in undertakings for collective investments are addressed by national law, which distinguishes them from other financial products or assets.

(b) Unit-linked life insurance products

Economic description. Unit-linked life insurance products, apart from offering biometrical risk coverage, can serve as savings products offered by insurance companies. The investment is made under a contract between the insurer and the investor, under which the insurer invests the money on the investor's behalf. The assets are owned by the insurance company, which promises to provide a return to the customer based on the investment performance of the underlying assets. In exchange for the amount invested, the investor is provided with a contractual right to a share in the income, profits or losses from a defined asset pool. The insurer may manage the assets on which the units are based, or use the money provided by the investor to buy units in a fund, or funds managed by third parties.

Customer segment. According to the life insurance industry, the vast majority of, if not all, unit-linked life insurance products are contracts with mass and affluent market policyholders, including high-net worth individuals.

Economic objectives. The purposes for which unit-linked life insurance products are purchased vary widely from retirement savings to tax-advantageous short-term investments. Depending on the investment objective, the importance of the insurance element can also vary. They are predominantly used for regular premium pension saving. Non-pension medium-term savings are mainly lump sums.

Investment features and restrictions. Unit-linked life insurance products can invest in UCITS as well as in non-UCITS like real estate funds. They also allow funds within a fund. There are no limits on liquidity.

Legal approaches. A unit-linked life insurance is a product offered by insurance companies. The investment is made under a contract between the insurer and the investor, under which the insurer owns the underlying assets on which any investment return is based. In exchange for the amount invested, the investor is provided with a contractual right to a share in the income, profits or losses from a defined asset pool. The insurer may manage the assets on which the units are based, or use the money provided by the investor to buy units in a given fund, or funds managed by third parties.

(c) Structured products

Economic description. Structured products/notes are securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency. In simpler terms, a structured product is essentially a contract between the investor and the issuer, usually an investment bank which promises to make at a certain time a payout based on a formula explained in the prospectus.

Customer segment. Although structured notes may be specifically designed to meet institutional investors' needs, market research suggests that in the EU the vast majority of structured notes issues are held by private individuals.

Economic objectives. Structured products intend: a) to yield superior returns than traditional bank deposits; b) to give investors access to complex investment strategies and a wider range of securities and asset classes that would not usually be available through traditional investment funds, for example, a specific basket of equities, commodities, foreign-exchange and hedge funds; c) to assure a certain level of liquidity; and d) to lower trading costs via economies of scale. Combinations of derivatives and financial instruments create structures that have significant risk/return and/or cost savings profiles that may not be otherwise achievable in the marketplace. Structured products are designed to provide investors with highly targeted investments tied to their specific risk profiles, return requirements and market expectations. Some structured products offer full protection of the principal invested, whereas others offer limited or no protection of the principal. In other cases, losses can be magnified by leverage.

Investment features and restrictions. Structured products are more complex in terms of investment strategies. They are generally not bound by any restrictions specifying the permissible level of market risk.

Legal approaches. Structured products may adopt different legal forms according to the market they target, the distribution channels they use or the jurisdiction where they are domiciled.

RESULTS AND DISCUTIONS

The main EU-wide legislative tools dealing with sales and advice do not cover all PRIPs, and in any case differ from each other in their approach. Sales of some PRIPs, such as structured term deposits, largely escape regulation under EU legislation and are subject only to national regulation.

Table 1

Overview of the Current Regulatory Framework

	UCITS funds	*Unit-linked life insurance products*	*Structured notes*	*Bank term deposits*
Product constitution	UCITS Directive	Life Directive	No rules at EU level	No rules at EU level
Capital requirement	UCITS Directive	Solvency I (to be replaced by Solvency II)	Capital Requirements Directive	Capital Requirements Directive
Independent oversight	Depositary of UCITS Directive	None at the insurance company level	No rules at EU level	No rules at EU level
Rules for disclosure to investors	Simplified Prospectus of UCITS Directive	Life Directive	Prospectus Directive	No rules at EU level
	MiFID for highlevel types of	Insurance Mediation Directive for	MiFID for highlevel types of	

	disclosure requirements	some disclosure requirements	disclosure requirements	
	E-commerce directive or Distance Marketing Directive			
Rules for selling	MiFID UCITS Directive	Insurance Mediation Directive	MiFID	No rules at EU level
	E-commerce directive or Distance Marketing Directive			

Source: European Commission April 2009 Communication

(a) In period 2008, EU Finance Ministers invited the Commission "*to review the consistency of EU legislation regarding the different types of retail investment products (such as unit-linked life insurance, investment funds, certain structured notes and certificates), so as to ensure a coherent approach to investor protection and to avoid any miss-selling possibilities.*"
(b) The UK concept of a packaged product includes, in addition to retail investment products, other products such as personal pension schemes and annuities. Most EU-based structured products adopt the legal form of a bond or a note, e.g. in Germany most structured products or certificates are bonds for legal and tax efficiency reasons. In France for instance, they may take the form of an investments fund, i.e. structured funds or formula funds where the assets in which the fund invests combine some secure investments with derivatives. But some French structured products are also bonds. Finally, in some countries, such as Belgium, structured products adopt the legal form of a life insurance contract.
(c) The Netherlands Authority for the Financial Markets states that "*the information provided to investors is not as it should be. Prospectuses do not focus sufficiently on the information that consumers need to make well-considered investment decisions. In addition, the legal entity chosen for the products means that financial information leaflets are not obligatory. This makes brochures the consumer's principal source of information. Brochures vary considerably in quality*".
(d) The Danish Central Bank confirms that "*the exact characteristics and costs of the [structured] products are difficult to assess for the individual investor". […] This makes it hard to distinguish the lotto coupons from the sound investments. Calculations […] show that the parties behind the index-*

linked bonds have historically made a good profit from the sale of these bonds. Investors, on the other hand, have incurred a risk that is higher than on investment in e.g. government bonds, without being rewarded with higher average returns".

(e) European Fund and Asset Management Association (EFAMA) states that "*In the past few years the number of competing products has increased steadily and with growing speed. This is not bad per se, but problems will arise if those products are not only less regulated and supervised than funds, but also less transparent and providing a lower level of investor protection. They are often not fully understood by the normal retail investor to whom they are offered with the same purpose as funds.*"

Future potential regulatory changes

Belgium. Plans to extend the MiFID conduct of business rules to some types of life insurance investment products are under discussion. This would apply regardless of whether they are sold directly by insurance companies or indirectly through insurance intermediaries.

Czech Republic. The disclosure and selling practice issues of similar investment product could be regulated in the same way regardless of the sector of origin. The scope in the insurance area would be based on profit-sharing.

Slovenia. Government has started procedure to amend existing Insurance Act where, among others, provisions regarding all costs charged to policyholder must be disclosed for all type of unit linked or index-linked contracts.

Estonia. Large-scale amendments concerning both the Estonian Credit Institutions Act and the Estonian Insurance Activities Act will be sent to the Parliament in the near future. If the amendment package is adopted, MiFID's suitability and appropriateness test will be applied to unit-linked life insurance and deposit-based retail structured products.

CONCLUSIONS

Financial innovation has paved the way for new instruments and techniques that may deliver features attractive to investors: tax optimization; capital protection; improved risk/return performance; tailoring to time horizons/risk profiles; flexible drawdown. However, the protection of retail investors is a key challenge in the context of an evolving financial services

landscape in the EU. It is essential to get the regime for PRIPs right given the essential role these products play in the lives of citizens by providing easy access to financial markets. The financial crisis did not start in the retail savings market but savers have suffered from falls in asset values and their confidence has deteriorated. Consumer saving rises in a recession and if Europe is to take advantage of this, a framework is needed where product features are clearly and transparently explained to customers and products are sold fairly and with the interests of the consumer in mind.

REFERENCES

1. ***Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance;

2. ***Société Générale Corporate & Investment Banking; The European Retail Structured Investment Products Market 2006, published in December 2006;

3. ***Report on the marketing of financial products, presented by Jacques Delmas-Marsalet to French Minister of the Economy, Finance and Industry, in November 2005;

4. ***Netherlands Authority for the Financial Markets, Exploratory analysis of structured products, in May 2007;

5. ***Committee on Economic and Monetary Affairs, Own-initiative report procedure: Report on financial services policy (2005-2010) - White Paper PE 384.621v03-00 A6-0248/2007; 28 June 2007;

6. ***http://ec.europa.eu/

7.***http://www.consilium.europa.eu/policies/council-configurations/economic-and-financial-affairs?lang=en

8. ***www.europe-economics.com