



Moving forward on investor protection

Background presentation to Q&A SESSION

European Parliament, Brussels · Tuesday, 18 September 2012 · 12,30h-14,30h

Co-hosted by MEPs

Giegold (Greens/EFA), Pietikäinen (EPP), Podimata (S&D),
McCarthy (S&D), Schmidt (ALDE) and Swinburne (ECRG)

Why investor protection?



a. Potential benefits

- To boost integration (so the single market)
- To promote long-term asset allocation
- To attract global investment flows by ensuring investors confidence
- To contribute to the generation of adequate returns and income for retirement through the creation of a more competitive market structure
- To ensure protection of retail investors from unfair predatory practices

b. These benefits may promote a more sustainable economic growth

c. Structural problems to be clarified:

- Provision of 'credence goods' (strong information asymmetry)
 - Withholding private information (e.g. conflicts of interest)
 - Insufficient financial education
 - Susceptibility of investors to framing by sellers (bounded rationality; e.g. loss aversion)
 - Uncertainty (unpredictable events)
- Focus on micro dimension (investors as purchaser of private good)
 - ≠ macro dimension (investor = taxpayer, as purchaser of public goods)

Key areas



1. Point of sale
2. Product and risk
3. Best execution
4. Market data



Point of sale

Point of sale



Provision of services

a. Acting honestly, fairly and professionally in accordance with the best interests of the client (art. 24, MiFID 2)

- Broad fiduciary duty : Effective supervisory mechanism is pre-condition!

b. Two ways to address failures:

1. Information to clients

- Pre-contractual disclosure
- Investment advice
- Ongoing disclosure

2. Provider and distributor's duties

- Suitability and appropriateness tests
- Professional standards

Information to clients



a. Two principles in disclosure:

- Comprehensive (no hidden risks or costs)
- Not misleading (including marketing materials)

b. Pre-contractual disclosure soon harmonised

- Helps investors to ‘shop around’ (as long as information is fully understood or read), so to take responsible investment decisions
- Harmonised under the KID for PRIPs

c. What about ongoing disclosure?

- Equally important disclosure of risks and costs
- Fragmented across MiFID, UCITS, IMD... and undeveloped

- What disclosure do investors need?
- To what extent can disclosure stimulate competition?

PRIPs KID



Covered by PRIPs	Not covered by PRIPs
<ul style="list-style-type: none">• Investment funds (UCITS/AIFs)• Unit-linked insurance policies• Structured products• Individual pension products• Securities that embed a derivative	<ul style="list-style-type: none">• Professional investors• Plain vanilla securities and bonds• Traditional deposits• Non-life and protection insurance• Occupational pension schemes

- **Ambitious enough?**

- Comparability across different product categories (level playing field)
 - Distortion in investment flows
- Non-conventional risks
 - Liquidity, custody and counterparty risks need some improved disclosure
 - Synthetic risk-reward indicator in KIID only captures market risks
- Responsible investing
 - Should be first defined to avoid use as marketing tool
- Complementary ongoing disclosure is missing!
 - Getting investors into something opaque?
- Broader political dimensions of where to direct savings

Disclosure is not enough...



a. Bounded rationality and rational ignorance!

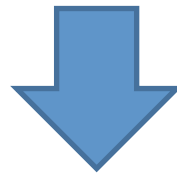
- Lack of financial literacy

*The duty of suitability rejects the prevailing paradigm of caveat emptor and forces providers [of the service] to internalise the harm that they cause when they exploit information asymmetries to the detriment of customers.
(Engel and McCoy, 2002)*

b. 'Know-your-customer' rule → Suitability test

c. 'Know-the-security' rule → Appropriateness test

- Non-advised services (such as reception and order transmission)



Fiduciary relationship

“Confidence, trust and influence” (Frankel, 1983)

Sale practices



a. Dismal evidence

- Most advisers (mostly ‘non-independent’)...
 - do not understand risks involved in products
 - do not collect sufficient information / follow poor recording
 - do not disclose inducements and conflicts of interest
 - some generate ambiguity on investors about their own responsibility
- Most clients not asked for ability to deal with risk / bear losses

b. Failure of MiFID I in the sale process?

- Probably an issue of implementation and supervision

c. Advised versus non-advised sales

- Are they correctly classified?

- Are tied sales genuine advice?
- Should the label ‘advice’ be used more rigorously?

What is advice?



a. Personal recommendation (CESR, 2010)

- Firm’s label to recognise it (as of today)

b. Two parameters:

- Range of products and providers considered: wide or narrow
- Costs: hidden inducements or transparent fees borne by the investor

		COSTS	
		Hidden	Transparent
RANGE	Wide	Comprehensive but non-independent?	Comprehensive and independent
	Narrow	Restricted and non-independent	Restricted but independent?

c. *Independent vs. non-independent advice?* [Commission’s proposal]

- Is the ban on monetary inducements a necessary and sufficient condition?
 - What about remuneration of sales staff?
- An other incentives not to behave in the client’s interest (e.g. churning)?

➤ Is there a better way to differentiate genuine advice?

The debate on inducements



a. Partial ban in MiFID I has not worked

- Difficult to apply and supervise (FSA, AMF, ESMA, art. 26 Impl. D.)

b. Two alternative approaches:

Disclosure Only		Disclosure + Separation
Hp*: investors can recognise independent advice	↔	Hp: investors cannot recognise independent advice
Broad definition of advice No limits on inducements Full fees/inducements disclosure	↔	Restricted definition of advice Banning inducements Full fees disclosure

c. Is the Commission's proposal an effective compromise?

- 'Non-independent' sales will still qualify as 'advice'
- 'Independent advice' still able to accept non-monetary inducements

**Hypothesis*

A fresh look at sale services



- **Full cost disclosure (pre-condition)**
 - All fees and costs communicated periodically to investors
 - Ongoing disclosure versus pre-contractual disclosure (KID)
- **A proposal for a dual regime:**

Pre-sale services		Investment advice
Full cost disclosure	↔	Full cost disclosure
Inducements allowed	↔	No inducements
Limited or broad range of products and providers	↔	Broad range of products and providers
Appropriateness test	↔	Suitability test
Sufficient professional standards	↔	Strict professional standards



Product and risk

Product complexity



a. Definition of *complexity*

- Understanding of risk/reward profile
 - Hidden market risks (e.g. tracking error in index replication funds)
 - Non-market risks (liquidity, counterparty, custody; e.g. synthetic ETF)
 - Product profile
- Complexity in product structuring

b. Implications if defined ‘complex’:

- Banned for ‘execution-only’ services (appropriateness test)
- Investors warned to find genuine investment advice
- Supervisory architecture and coordination
 - Screening of products, leading to sale restrictions
- A case for product rules (e.g. UCITS)?

- Is complexity a matter for regulation or supervision?
- How to coordinate supervisory action on complex products?
 - Are some UCITS complex?



Best execution

Best execution



a. It applies to

1. Execution of orders on behalf
2. Reception and transmission of orders
3. Portfolio management

b. For all financial instruments, excluding spot FX instruments

c. Obligation of 'results' or 'means'? (art. 24, MiFID II) → 'dynamic'

d. Too loose definition (art. 27.1, MiFID2; art. 44, Imp D)

- 'Price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration'
- Considering characteristics of the client, venue and order, plus instructions from the client.
- For retail, 'price and cost'
 - ...but 'For the purposes of delivering best execution where there is more than one competing venue to execute an order for a financial instrument, in order to assess and compare the results for the client that would be achieved by executing the order on each of the execution venues listed in the firm's order execution policy that is capable of executing that order, the firm's own commissions and costs for executing the order on each of the eligible execution venues shall be taken into account in that assessment.' (art. 44.3, Imp Dir)

Execution policies and data



a. Execution policy has become box ticking (too long!)

- Too long and not regularly updated... (ECMI Survey, 2011)
- Like KID

b. Execution quality data (art. 27.2/27.5, MiFID II)

- Trading venues (quality of execution; yearly)
- Investment firms (top 5 venues)

c. An easier definition to implement?

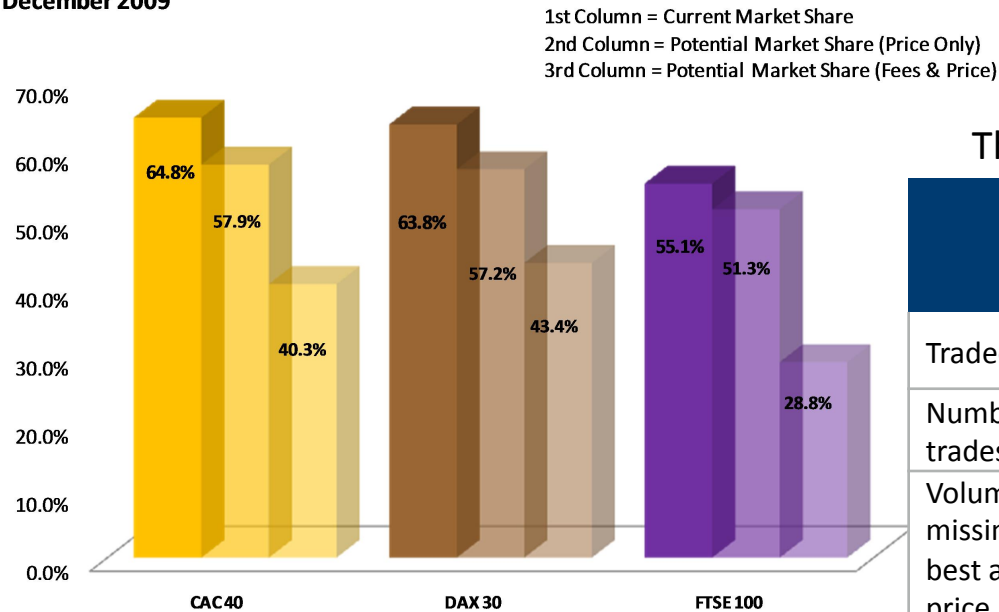
- Price as 'default rule'
 - Leave parties to amend rule with additional criteria (bilaterally)
 - Boost competition and easier to enforce

Execution for retail clients



Is there really best execution for retail investors?

December 2009



The 1,000 + most liquid stocks (January 2010)

	Most liquid stocks in Europe	FTSE 100	CAC 40	DAX 30
Traded volume	€341.22 Bn	€122.30 Bn	€77.26 Bn	€61.32 Bn
Number of trades	48.08 Mn	17.80 Mn	9.52 Mn	5.40 Mn
Volume missing the best available price	45.38 Bn 13.30%	14.36 Bn 11.74%	11.13 Bn 14.40%	9.14 Bn 14.90%
Number of trades missing the best available price	5.37 Mn 11.2%	1.84 Mn 10.4%	1.23 Mn 12.9%	0.70 Mn 13.0%
Costs	€12.38 Mn	€4.00 Mn	€2.5 Mn	€1.65 Mn
Potential average price improvement	3.3 Bps	3.5 Bps	2.5 Bps	2.4 Bps

Recent statistics (January 2010 on the 1,000 + most liquid stocks – Europe)

Execution for retail clients



MARKET ORDERS

# executed orders: 67,893 Total Price Improvement: 83,855 €	All market orders	Order Size				
		< 5K€	5 to 10K€	10 to 20K€	20 to 50K€	> 50K€
• Proportion of orders receiving a better price than on HM	37%	31%	44%	56%	72%	82%
• Average Price Improvement for these orders - Bps	3.25	3.88	3.0	2.81	2.25	2.26
• Average Price Improvement for these orders - €	3.29 €	0.66 €	2.21 €	3.94 €	7.07 €	16.06 €
• Max PI in €	-	96 €	232.06 €	195.70 €	209.10 €	544 €
• Average theoretical number of SOR executions	2.5	1.4	2.4	3.1	4.2	6.5
• Average theoretical number of venues involved	1.9	1.3	2.0	2.4	2.8	3.5

•Source: Equiduct

Remarks



- **New forms of conflicts of interests**

- Ownership stake of investment firms in the trading platform where they route own clients 'orders → disclosure requirements?
 - Payment to brokers to receive order flows, which are then matched against investment firms' capital owning the venue (typically HFT firms)
- As long as best execution obligation is effectively implemented, this should not be a problem.
 - A problem for competition authorities, to ensure fair competition among trading venues



Market data

Market data



a. Missing piece of the pan-European market for shares

- Linking-up multiple venues
- Literature suggests additional positive effects of competition at trading level (with related market fragmentation) for end-users if information from all sources of information is consolidated, pre- and post-trade (it is also a prerequisite for effective supervision as well)

b. Post-trade data consolidation

c. Consolidated tape

- Commission has chosen 'Option C'
 - Avoiding risks with price regulation (*e.g.* US experience)
 - Competing CTPs (tapes)

- Why is there no focus on quotes (ex-ante) consolidation?
- Is data equally accessible to all market participants (with equal terms)?

Impediments to consolidation



a. Data formats and flags (e.g. OTC trades)

- APAs (for IFs, venues)
- Demand and supply segmentation by incumbents
 - Reduce interoperability
 - Lock-in customers
 - Enforcing competition policy if APAs do not deliver soon

b. Market practices

- Cross-selling practices by data sources
 - Bundling pre and post-trade transparency (exchanges)
 - Bundling for data across shares (exchanges and data vendors)
- Lack of interoperability among trading venues
 - Competition on trading can directly affect data revenues
- Lack of interoperability among data platforms
 - Increasing costs to 'shop around'

c. Lack of demand for post-trade data solutions



Horizontal view

A horizontal view



	AIFs	UCITS	INSURANCE PRODUCTS	LISTED SECURITY	Un-listed security/ structured products
Selling Practices	AIFMD + local rules	MiFID UCITS Local rules	IMD + local rules	MiFID Prospectus Directive	MiFID
Distance Marketing of Financial Services Directive					
Pre-contractual disclosure	AIFMD + local rules	UCITS IV (KID)	IMD + local rules	MiFID Prospectus Directive	
Asset Allocation	Local rules	UCITS	Solvency II		
Prudential	AIFMD MiFID CRD	UCITS MiFID CRD	Solvency II		

PRIPs?

?



Additional issues

Remarks



a. **Strict liability for depositories (delegation)**

- Are there hidden investor protection's trade-offs?
- Are segregation rules well-crafted?

b. **Is there anything that regulation can do with markets that aggregate diverse investment habits?**

- Or are investment habits frequently fostered by fragmented national regulatory frameworks?
- It may be a 'chicken and egg' problem!

c. **Deposit guarantee and investor compensation scheme**

- Any issue or potential overlap (increased cost?) there for investor protection at micro level?