PRODUCT INTERVENTION: A EUROPEAN PERSPECTIVE

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INTRODUCTION 27

I. THE CONTEXT: RETAIL INVESTMENT MARKETS – ITS CHALLENGES AND THE REGULATORY RESPONSE 28

II. PRODUCT INTERVENTION AT EUROPEAN LEVEL 31
- A. The UCITS regime 31
- B. The PRIPs initiative 32
- C. The ESMA Regulation 34
- D. MiFID 34
  1. Additional requirements in national legislation 35
  2. Removal from trading by competent authorities 36
  3. Complex v non-complex products 36
- E. MiFID Consultation, CESR Technical Advice and the proposals MiFID II and MiFIR 37
  1. Increased product information 38
  2. Organisational requirements 39
  3. Product bans 40
  4. Complex v non-complex products 45

III. PRODUCT INTERVENTION AT NATIONAL LEVEL 46
- A. The Belgian moratorium and contemplated regulation on the distribution of structured products to retail investors 46
- B. The French *de facto* ban 50
- C. The UK approach to product intervention 52

CONCLUSIONS 55

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Introduction

In a narrow acceptance, product intervention refers to the rules dealing with the design and the structure of investment products carrying out particular risks, notably complex retail investment products. It comes next to the set of regulations concerning disclosure and distribution of those products.

The European Commission seems increasingly eager to intervene in product design and structure, adopting a more intrusive style of regulation of (complex) retail investment products, to face the persisting problems which were not resolved with distribution and disclosure regulations. The European regime for collective undertakings (UCITS regime) was the first illustration of European investment product regulation, focusing on product design. It dates back to 1985. The directive that regulates financial markets and investment firms (MiFID) contains several provisions reflecting product intervention. The MiFID entered into force in November 2007. The new European supervisory authority (the European Securities and Markets Authority or ESMA) established in 2009 was granted powers to temporarily prohibit or restrict financial activities under certain circumstances and is another illustration of product intervention. The packaged retail investment products (PRIPs) initiative launched in 2007 contemplated point-of-sale regulation although the key concern of the draft "Regulation on key information documents for investment products" tabled in July 2012 is product disclosure. Lastly, some changes contemplated by the revision of the MiFID (the MiFID Review), which proposals were published in October 2011, also suggest product regulation, and in particular the possibility to banning specific activities, products or practices.

In such context, this article wishes to contribute to the debate on how to best regulate European retail financial markets.[1] To better inform the discussion on whether or not an intrusive regulatory approach has merits at European level, various Member States' interventionist initiatives are

[1] See on the same subject, Niamh Moloney, "Regulating retail financial products: the financial crisis and the EU challenge" (2010) 11 *ERA Forum* 329 and Niamh Moloney, "Regulating the retail markets: law, policy and the financial crisis" (2010) 63 *Current Legal Problems* 375.

considered, namely the ones contemplated or adopted by Belgium, France and the UK.

The author concludes that disclosure, distribution and product intervention are complementary regulatory tools to be used by the European Commission. They each have their merits and their limits. The rules that have been adopted under each of them need to be refined to tackle the persisting issues in financial markets. Before doing so, the European Commission should take the time to perform complete and objective costs-benefits analyses.

I. The context: retail investment markets – its challenges and the regulatory response

The most common type of investments made by European retail investors are retail investment products.[2] Retail investment products stand for a wide range of investment products, regardless of their legal form, where the amount repayable to the investor is exposed to fluctuations in reference values or in the performance of one or more underlying assets that the investor does not directly purchase or sell. They include all investment funds (and not only UCITS funds), structured products (whether packaged as insurance policies, funds, securities, bank deposits, or otherwise), certain insurance products and derivatives.

European retail financial markets are a source of finance to support the economy as a whole.[3] Next to this economic goal, there is a clear political objective to promote retail investors' participation in European fi-

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2 See Decision Technology Ltd, *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective*, Final Report, November 2010 [Decision Technology Final Report]; BME Consulting, *The EU Market for Consumer Long-Term Retail Savings Vehicles: Comparative Analysis of Products, Market Structure, Costs, Distribution Systems, and Consumer Savings Patterns*, Final Report, 15 November 2007 [BME Consulting Final Report]; research by Structured Retail Products Ltd.

3 The size of the European retail investment market was valued at over 9 trillion in 2009 by the European Commission's impact assessment relating to its PRIPs proposal of 3 July 2012: EC, Comission, Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on key information documents for investment products, 3 July 2012, COM(2012) 352 final 2012, online: <http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/20120703-proposal_en.pdf> [PRIPs proposal].

nancial markets,[4] as they contribute to enhance households' individual financial planning and welfare provision at a time when governments seem to withdraw from the provision of public pension and public education.[5]

However, retail financial markets are beset by important market failures.[6] There are strong information asymmetries between investors and originators/distributors/advisers, which in turn give rise to mis-selling and mis-buying risks. Agency problems exist as those producing/selling/advising on investments face conflicts between their own interests and those of their clients/investors, which in turn lead to distribution risks.[7] In addition, as behavioural finance work focusing on retail investors shows, retail investors are generally poorly diversified[8] and most of the time lack sufficient competence to correctly understand financial markets and the disclosures that are made to them.[9] They are also subject to behavioural biases, such as the pro-cyclical herding tendencies.[10]

These risks are exacerbated in connection with structured products,[11] which are often complex and opaque.[12] In addition, the structured pro-

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4 See European Consumer Policy Strategy 2007-2013 (underlying the importance of empowering consumers, as a key driver to innovation, competition and productivity).

5 See Luigi Zingales, "The Future of Securities Regulation" (2009) 47 *Journal of Accounting Research* 391.

6 See SWD(2012)432, The Consumer Markets Scoreboard, 8th edition, December 2012 (according to which last place goes for the third year in a row to the market for investment products which is characterised by substantial market malfunctioning).

7 See Synovate, *Consumer Market Study on Advice within the Area of Retail Investment Services*, Final Report, 2011 (reporting that, during their investigation, "very few advisors mentioned conflicts of interest or inducements during the engagement").

8 See BME Consulting Final Report, *supra* note 2.

9 See Decision Technology Final Report, *supra* note 2 at 385.

10 *Ibid.* (citing, in approximate order of diminishing importance: cognitive limitations, trust in advice, attitudes to risk and ambiguity, framing effects, familiarity and other heuristics).

11 For a definition, see FSA, *Guidance Consultation, Retail Product Development and Governance – Structured Products Review*, March 2012, at 2 [FAS, *Guidance Consultation*].

12 *Accord* Decision Technology Final Report, *supra* note 2, at 389; FAS, *Guidance Consultation*, *supra* note 11 at 2 and 3.

duct market presents a liquidity risk as structured products are designed as medium to long term illiquid investments. It also has specific design and development weaknesses. First, product providers often lack sufficient incentives to target products to investors' needs, since this involves some costs, such as research and review of management information. Second, product providers have a tendency to give inadequate consideration to the information needs of investors during the design process, hampering consumers' understanding of products. Third, investors are generally unable to judge the value and quality of some products because of their opaque and/or complex product features, which can be inadequately communicated by product providers and intermediaries. Ultimately, these problems give rise to the risk of a poor match between investors' needs and the products they purchase. With those products, product design, rather than asset management could dictate the risk-return profile.

To make retail financial markets a success, investors' confidence is crucial. Even more so after the financial crisis as 2 trillion of losses were sustained between end of 2007 and end of 2008 in the European packaged retail investment products' market. Confidence largely depends on appropriate rules and regulations. However, the priority of the European Commission after the financial crisis seemed to be the stabilisation of financial markets and the banking sector and not so much retail financial markets weaknesses.[13] Nonetheless, European instances seem to be conscious of the need to address the flaws in the European retail investment market identified during the financial crisis. The European initiative on standardised pre-contractual information on packaged retail investment products (PRIPs)[14] as well as important parts of the MiFID Review[15] are illustrative in that respect. They specifically aim at resolving issues rela-

[13] See EC, Commission, *Communication for the spring European Council: Driving European recovery*, 4 March 2009, COM(2009)114, final2009) (mentioning as most important components of the European Commission agenda systemic risk and financial stability (new framework for financial supervision and the oversight of systemic risk), cross-border crisis management framework, derivatives reforms (EMIR), the MiFID Review, review of the market abuse directive, executive compensation (new capital requirements directive and new alternative investment fund managers directive), credit rating agencies and securitisation (new credit rating agencies regulation and new capital requirements directive), alternative investment fund managers regulation (alternative investment fund managers directive)).

[14] See below.

[15] See below.

ting to insufficient and unsatisfactory product information and conflicts of interests in the distribution chain.

II. Product intervention at European level

A. The UCITS regime[16]

The UCITS regime[17] was the first illustration of product intervention by the European Commission. It is a product design regulation, which provides for the authorisation of the product for marketing to the public, and more specifically for a European marketing passport for UCITS and their management companies.[18] The UCITS conquered a global reputation and became a strong brand within the EU for collective investment scheme design and investor protection. It is now the preferred investment vehicle of the European Commission for supporting long-term savings and is increasingly popular with retail investors.[19]

Product regulation offers many advantages in the collective investment schemes' context. The regulator could steer retail investors towards preferred outcomes and in particular asset allocations which hedge against market risk. Regulation could combine protection with support of diversification and access to a range of investment strategies. It could address product clarity, simplicity and costs. Asset allocation rules and governance requirements could alleviate the risks associated with disclosure regula-

[16] This section heavily draws from Niamh Moloney, *How to Protect Investors. Lessons from the EC and the UK* (Cambridge: Cambridge University Press, 2010) at 134-91.

[17] The regime relating to Undertakings for Collective Investment in Transferable Securities (UCITS regime) was conceived in 1985 and subsequently underwent important changes. Major reforms in 2002 significantly increased the range of assets in which UCITS can invest (the UCITS III reforms). A further set of reforms was recently adopted (key investor information (KII), master-feeder structures, notification procedure for the passport, funds mergers, depositary) and are hereinafter referred to as UCITS IV (EC, *Directive 2009/65/EC*, 17 November 2009, L 302/32). The draft UCITS V was published on 3 July 2012 (depositary, remuneration). A consultation of the European Commission on UCITS VI closed on 18 October 2012 (money market funds, depositary passport, liquidity management tool).

[18] EC, *Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)*, [1985] O.J., L 375/3.

[19] See EFAMA annual reports.

tion. Product design and labelling techniques could mitigate distribution and advice regulation risks.

But product regulation in the context of collective investment schemes has not proved entirely successful. There are doubts about its ability to manage market and conflict-of-interest risks or support effective diversification. There are also many design challenges as the choices concerning the structure and engineering of the financial products would probably be made more efficiently by the industry, not the regulator. Product regulation in this area is also likely to obstruct innovation, might become rapidly obsolete given financial innovation, and might impose a "one-size-fits-all" which is not likely to support investor learning and varying degrees of risk appetite. Besides, heavy regulation while substitute products remain largely unregulated and available leads to regulatory arbitrage. This concern could support more product regulation or, alternatively, the recognition that regulatory resources have been misallocated as retail investors prefer opaque and complex, although less regulated, insurance-related products and structured products. There are remaining concerns that retail investors are not provided with appropriate products that suit their needs and level of sophistication.

B. The PRIPs initiative and the regulation on key information documents for investment products

It is worth briefly discussing the evolution in the approach of the European Commission in connection with retail investment products.

In its Communication which launched its initiative relating to "packaged retail investment products" (PRIPs),[20] the European Commission suggested that the current disclosure and distribution/advice "fragmented regulatory patchwork" under the MiFID, the UCITS regime, and the prospectus directive, should be replaced by a coherent, cross-sector horizontal "selling" and disclosure regimes addressing conflicts of interests, inducements and conduct of business regulation in retail investment products. Disclosure and point-of-sale regulation through increased focus on the originator's responsibilities in the product design process, market testing, stress testing or choice of distribution channel, were believed to

[20] EC, Communication from the European Commission to the European Parliament and the Council on Packaged Retail Investment Products, COM(2009) 204 final, 30 April 2009.

lead to a coherent and consistent harmonized investor protection regime. Since the Communication, and throughout various discussions, including at some so-called Level 3 committees, the PRIPs initiative showed an awareness of the limitations of the UCITS IV key investor information document to serve as template to be extended to all PRIPs. It also focused on MiFID's weaknesses regarding the commission risks and the execution-only regime with respect to PRIPs.

The European Commission recognised in the November 2010 Consultation that it would be preferable to amend MiFID and the insurance mediation directive to address the PRIPs issues on sales rules.[21] Consequently, it suggested in its proposal of MiFID II (see references below) making more uniform regulatory treatment concerning the distribution of different packaged retail investment products in order to ensure an adequate level of investor protection across the EU,[22] and notably included structured deposits in the scope of MiFID II.[23] This means that MiFID conduct of business rules, conflicts of interest rules and other organisational requirements are likely to apply to them in the future.

On the other hand, the final report of the behavioural study commissioned by the European Commission suggested that simpler and standardised product information could greatly improve EU consumers' investment decisions.[24] The draft Regulation on key information documents on investment products of 3 July 2012[25] therefore suggests that sales of investment products be accompanied by a key information document (KID). Such document should be prepared by the product manufacturer and be provided by the person selling the investment product. It should provide retail investors with short, clear and comparable information written in accordance with a common standard.

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21 See Consultation by Commission Services on legislative steps for the Packaged Retail Investment Products initiative, 26 November 2010 (closed on 31 January 2011).

22 See recital (26) of draft MiFID II.

23 See article 1.3 of draft MiFID II.

24 Decision Technology Final Report, *supra* note 2 at 19.

25 The draft legislation will now be subject to a trialogue of discussions between the Commission, the EU Council and the EU Parliament. The current goal of the Commission is for implementation of the proposals by the end of 2014.

C. The ESMA Regulation

According to Recital (12) and Article 9.5 of the ESMA Regulation,[26] ESMA may *temporarily* prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EU. It may do so in the cases specified and under the conditions laid down in the directives and regulations relating to firms providing investment services or to collective investment undertakings marketing their units or shares and the competent authorities that supervise them. It may as well do so in the case of an "emergency situation"[27] in accordance with and under the conditions laid down in Article 18.[28]

ESMA shall review its decision at appropriate intervals and at least every 3 months. If the decision is not renewed after a three-month period, it shall automatically expire. It is also provided that a Member State may request ESMA to reconsider its decision.

ESMA may also assess the need to prohibit or restrict certain types of financial activity and, where there is such a need, inform the European Commission in order to facilitate the adoption of any such prohibition or restriction.

D. MiFID

MiFID came into force on 1st November 2007. It sought to provide the harmonisation needed to offer investors a consistently high level of protection across the full range of investor-oriented activities within its scope, i.e. investment services and activities.

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26 CE, *Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 Novembre 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC*, [2010] O.J., L 331/84.

27 See definition and procedure in *ibid*. at Article 18.2.

28 First, facilitation and coordination of any action undertaken by competent authorities; second, individual decisions to competent authorities; third, individual decision to a financial market participant.

1. Additional requirements in national legislation

MiFID is said to be a maximum harmonisation directive. It means that as a matter of principle Member States are prevented from imposing additional requirements on duly authorised firms and activities.

This being said, as an exception to this prohibition of any gold plating by Member States, Article 4 of MiFID Implementing Directive[29] allows Member States to impose additional requirements to investment firms under specific conditions. They must be objectively justified and proportionate so as to address specific risks to investor protection or to market integrity that are not adequately addressed by MiFID. And the specific risks they address must be of particular importance given the market structure of the Member State or they must not be otherwise regulated by or under European measures. It is further provided that these additional requirements imposed by a Member State must not affect the freedom of duly authorized foreign investment firms to provide services in that Member State through a subsidiary or a branch.[30] Lastly, it is provided that Member States must notify to the European Commission any requirement which it intends to impose at least one month before its entry into force, with due justification.

However, the possibility for Member States to provide additional requirements to investment firms under certain conditions is not foreseen anymore in the proposal for a recast of MiFID (draft MiFID II) and in the new regulation (draft MiFIR). The draft MiFID II and the draft MiFIR are currently only at the stage of Commission proposals and are subject to further amendment by the European Parliament and the European Council during the European legislative process.[31] It can be reasonably expected that many of the Member States in the Council will seek to

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[29] EC, *Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive*, [2006] O.J., L 241/26.

[30] Article 4.2 which refers to Articles 31 and 32 of MiFID.

[31] The plenary sitting of the European Parliament for first reading is scheduled to take place on 24 October 2013.

water-down the relevant provisions in order to preserve the power of their local regulators.[32]

2. Suspension of/removal from trading by competent authorities

MiFID provides that competent authorities may, to the extent national law so provides, require the suspension of or removal from trading of a financial instrument, whether on a regulated market or under other trading arrangements.[33]

The draft MiFID II does not seem to change this.[34]

3. Complex **versus** *non-complex products*

The MiFID appropriateness requirements aim to increase the protection of investors – particularly retail investors – who intend to make investments without receiving advice from an investment firm. They reduce the possibility of complex products being sold on an "execution-only" basis to retail investors who do not have the experience and/or knowledge to correctly understand the risks of such products.

The risk-based way in which the requirement applies, and what it should involve in each case, depends particularly on the nature of the in-

32 See the Presidency compromise text of MiFID II dated 3 December 2012, in particular draft Recital 52 ("This Directive provides for conditions and procedures for Member States to comply with when planning to impose additional requirements. Such requirements may include prohibiting or further restricting the offer or acceptance of fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of service to clients. Member States may retain any requirements additional to this Directive which have been notified under Article 4 of Directive 2006/73/EC at the time this Directive enters into force"); draft Articles 16.11A; 24.8; 36.1.

33 Article 50.2 (k) MiFID.

34 See article 72.1 (e) draft MiFID II (which reads "[c]ompetent authorities shall be given all supervisory remedies that are necessary for the exercise of their functions. Within the limits provided for in their national legal frameworks, they shall exercise such remedies: [...] (d) require the suspension of trading in a financial instrument; (e) require the removal of a financial instrument from trading, whether on a regulated market or under other trading arrangements; [...]". See the slightly amended Article 71 of the Presidency compromise dated 3 December 2012 (the last published at the time of writing of this article).

vestor, i.e. whether retail or professional, and on the type of MiFID financial instrument that is involved in the transaction. In terms of the type of financial product, the way in which the appropriateness requirements apply differs according to whether the instrument is deemed "non-complex" or "complex" for these purposes. In practical terms, the distinction between complex and non-complex products matters because the appropriateness test must always have been undertaken by an investment firm where the service or transaction involves a "complex" product. For "non-complex" products, the test does not need to be undertaken in certain specified circumstances – meaning that the resulting transactions can be carried out as "execution-only".

Article 19(6) of MiFID lists specific types of financial instruments that can always be treated as non-complex for these purposes. Article 38 of the MiFID Implementing Directive then provides a set of criteria for "other non-complex" products not specifically listed. These provisions together also indicate some specific types of MiFID products that should always be treated as "complex" for the purposes of the appropriateness requirements. However, MiFID does not seek to provide definitive or complete lists of all types of products and how they should be categorised.[35]

E. MiFID Consultation, CESR Technical Advice and the proposals MiFID II and MiFIR

MiFID provides for its own revision.[36] The purpose of the revision is to update the original directive to take account of the ongoing fragility of the financial system, the burgeoning European consumer protection agenda, and increased diversity in both financial instruments and trading methods.

In that context, the European Commission published in December 2010 a public consultation which closed in February 2011 (the MiFID Consultation).[37] It sought industry responses *inter alia* on a number of important areas for retail investors. The suggestions of interest for the

35 See below for the proposal MiFID II in that respect.

36 Article 65 of MiFID.

37 See online: <http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf>.

purposes of this article are those that relate to product regulation. These concern complex products[38] and are developed below.

The drafts MiFID II and MiFIR were published on 20 October 2011.[39] The provisions relating to product intervention are detailed below.

To be exhaustive, it should be noted that, following a public consultation, the Committee of European Securities Regulators (CESR, predecessor of ESMA) issued in July 2010 a technical advice on MiFID's distinction between complex and non-complex financial instruments for the purposes of MiFID's appropriateness requirements.[40]

1. Increased product information

The European Commission suggested in the MiFID Consultation to strengthen product information by providing, prior to the transaction, a risk/gain and valuation profile of the instrument in different market conditions. It also suggested providing, during the life of the product, quarterly valuations of complex products, and in the case of structured products, quarterly reporting on the evolution of the underlying assets during the lifetime of the product.

Market participants' responses in that respect were rather negative as more disclosure entails costs and related liabilities for intermediaries without proven benefits for the end-users. One concern was the alignment and consistency with the proposals being discussed in the context of the PRIPs initiative. Another one was the fact that the requirements should be strictly limited to retail clients only.

The draft MiFID II provides that the reports to be submitted to clients must include "periodic communications", "taking into account the type and the complexity of financial instruments involved and the nature of

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38 Note that the European Commission also suggested additional disclosure requirements for complex products in questions 95 to 100.

39 See the European Commission web-sites for the text of the proposals and an impact assessment.

40 See CESR, *Consultation paper: CESR Technical Advice to the European Commission in the context of the MiFID Review – Investor Protection and Intermediaries*, CESR/10-417, 13 April 2010 [CESR/10-417]. CESR, *CESR Technical Advice to the European Commission in the Context of the MiFID Review – Investor Protection and Intermediaries*, CESR/10-859, 29 July 2010, [CESR/10-859].

the service provided to the client" and must "include, where applicable, the costs associated with the transactions and services undertaken on behalf of the client. When providing investment advice, the investment firm shall specify how the advice given meets the personal characteristics of the client."[41] It also provides that, when investment advice is provided, information to clients shall specify whether the advice is provided on an independent basis and whether it is based on a broad or on a more restricted analysis of the market and shall indicate whether the investment firm will provide the client with the on-going assessment of the suitability of the financial instruments recommended to clients.[42]

2. Organisational requirements

The MiFID Consultation also proposed structural organisational changes for firms to enhance retail investor protection by stressing the relevance of organisational requirements "at the stage when firms design and shape their general policies and decide the products, operations and services that will be offered to retail and professional clients; this would be particularly relevant in the case of new products or variations to existing services provided by the firm".[43] The European Commission's suggestions in that respect included establishing duties requiring firms to consider the ultimate consumer at the "design and build" stage for new products. For instance, ensuring that new products are compatible with target client needs, stress testing products, periodic reviews of distribution and performance, requirements for adequate staff training and expertise to understand the characteristics and risks of products and establishing effective oversight at board level.

The draft MiFID II provides that the members of the management body of the investment firm must at all times be "of sufficiently good repute, possess sufficient knowledge, skills and experience and commit sufficient time to perform their duties", all these requirements to be further detailed in ESMA regulatory technical standards. It means that, *inter*

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41 Article 25.5 draft MiFID II (changed slightly in the last available Presidency compromise).

42 Article 24.3, first indent, draft MiFID II (remained the same in the last available Presidency compromise).

43 MiFID Consultation, at 68 referring to Section 1, Chapter II of MiFID Implementing Directive.

alia, the management body shall possess "adequate collective knowledge, skills and experience to be able to understand the investment firm's activities, and in particular the main risk involved in those activities". It is also provided that investment firms must devote "adequate resources to the induction and training of members of the management body". More surprisingly as it could have important implications depending on how it is applied, it is also provided that the management body must ensure that the "firm is managed in a sound and prudent way and in a manner that promotes the integrity of the market and the interest of its clients. To this end, the management body shall (a) define, approve and oversee the strategic objectives of the firm; (b) define, approve and oversee the organization of the firm, including the skills, knowledge and expertise required to personnel, the resources, the procedures and the arrangements for the provision of services and activities by the firm, taking into account the nature, scale and complexity of its business and all the requirements the firm has to comply with; (c) define, approve and oversee a policy as to services, activities, products and operations offered or provided by the firm, in accordance with the risk tolerance of the firm and the characteristics and needs of the clients to whom they will be offered or provided, including carrying out appropriate stress testing, where appropriate; (d) provide effective oversight of senior management. The management body shall monitor and periodically assess the effectiveness of the investment firm's organization and the adequacy of the policies relating to the provision of services to clients and take appropriate steps to address any deficiencies."[44]

3. *Product bans*

Under the heading "reinforcement of supervisory powers in key areas", products bans was envisaged in the MiFID Consultation.

First, the MiFID Consultation suggested that in case of significant and sustained investor protection concerns or if there is a threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system, the European Commission should be able to ban the provision of investment services and the carrying out of investment activities in certain financial instruments. The European

[44] See article 9 proposal MiFID. See the slightly revised version in the last published Presidency compromise.

Commission added that these measures should, except in extraordinary circumstances, require consultation, be based on appropriate evidence of risks and require cost/benefit analysis.[45]

Second, national regulators should be given the power to temporarily ban or restrict products in case of exceptional adverse developments which constitute a serious threat to financial stability or to market confidence in a Member State or the European Union. The exercise of this power could be pre-notified to and coordinated through ESMA.

Third, when a competent authority has not taken measures to address a threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system arising from the distribution of a product or the provision of an activity, or the measures that have been taken do not sufficiently address the threat, it would be necessary to create the relevant mechanism at European level to ban in a temporary manner the distribution of such product or the provision of such activity.

It flows from the above that product intervention could only occur under limited circumstances, and be either organised or coordinated at the European level.

As acknowledged by the European Commission, product bans could have significant consequences for market participants and businesses. Most market participants having replied to the MiFID Consultation expressed their concerns with the European Commission's suggestions in that respect.[46] They raised the problem that the issue is a global one as the European Commission would not have the remit to ban directly certain products, such as a non-EU unregulated collective investment scheme. Another concern of market participants was how some of the proposals relating to European banning mechanisms would relate to the existing powers under MiFID and the ESMA Regulation (see above). In essence, existing provisions of the ESMA Regulation, together with the existing powers of competent authorities and the obligation to cooperate under MiFID, could be sufficient to achieve the European Commission's objectives in this regard. Lastly, recent history with short-selling prohibitions has shown that product bans create important issues in terms of application and that it distorts the level playing field. The possibility for

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[45] See MiFID Consultation, at 80.

[46] See conclusions of this article.

a competent authority to apply a ban could create significant market discrepancies within the EU, which runs against the objective of harmonisation embedded in MiFID. If we are to maintain harmonised financial markets in the EU, an efficient escalation process would need to be defined to ensure a competent authority can call up ESMA quickly on a matter of market disorder or systemic risk and ESMA can examine it rapidly, according to precise and clear criteria.

Under the explicit heading "Product intervention by competent authorities", the draft MiFIR grants power to Member States' competent authorities to prohibit or restrict in or from the relevant Member State (a) the marketing, distribution or sale of certain financial instruments or financial instruments with certain features; or (b) a type of financial activity or practice under certain conditions.[47] The following conditions must be satisfied on reasonable grounds: (a) there must be significant investor protection concerns or a serious threat to the orderly functioning and integrity of financial markets or the stability of whole or part of the financial system; (b) the risks are not sufficiently addressed by existing regulatory requirements under European legislation applicable and the issue is not better addressed by improved supervision or enforcement of existing requirements; (c) the action must be proportionate taking into account the nature of the risks identified, the level of sophistication of investors or market participants concerned and the likely effect of the action on investors and market participants who may hold, use or benefit from the financial instrument or activity; (d) the competent authority must have properly consulted with competent authorities in other Member States that may be significantly affected by the action; and (e) the action must not have a discriminatory effect on services or activities provided from another Member State. The competent authority may provide for circumstances or exceptions relating to the prohibition or restriction. There must be one month prior notification by the competent authority to all other competent authorities and ESMA in writing.[48] That notification must include details of, *inter alia*, the entry into force of the measure and the evidence upon which the competent authority has based its decision and upon which it is satisfied that each of the conditions of MiFIR are

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47 Article 32 draft MiFIR. The same provision in the most recently published Presidency compromise (dated 3 December 2012) has been slightly modified.

48 See exception to one (1) month prior notice in the last available Presidency compromise dated 3 December 2012.

met. The prohibition or restriction may only apply in relation to actions taken after the publication of the notice on the authority's web-site. A prohibition or restriction can only be *for limited time*, and must be revoked if the conditions no longer apply. The European Commission will take delegated acts specifying criteria and factors to be taken into account by competent authorities in determining when the threats to investor protection or to the orderly functioning and integrity of financial markets and to the stability of the whole or part of the financial system of the EU referred to above arise. These criteria and factors shall include (a) the degree of complexity of a financial instrument and the relation to the type of client to whom it is marketed and sold; (b) the size or the notional value of an issuance of financial instruments; (c) the degree of innovation of a financial instrument, an activity or a practice; (d) the leverage a product or practice provides. This could potentially become an important limitation to the competence of local authorities to issue new bans.

Worth noting is the role of ESMA as facilitator and coordinator in relation to action taken by competent authorities under their right to intervene under the draft MiFIR as detailed above.[49] In particular ESMA shall ensure that action taken by a competent authority is justified and proportionate and that where appropriate a consistent approach is taken by competent authorities. After receiving notification of any action that is to be imposed by a competent authority, ESMA shall adopt an opinion on whether it considers the prohibition or restriction is justified and proportionate. If ESMA considers that the taking of a measure by other competent authorities is necessary to address the risk, it shall also state this in the opinion. The opinion shall be published on ESMA's website. Where a competent authority proposes to take, or takes, action contrary to an ESMA opinion or declines to take action contrary to an ESMA opinion, it shall immediately publish on its website a notice fully explaining its reasons for doing so.

In addition, and as already mentioned above, ESMA was granted the power under the ESMA Regulation to temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EU in the cases specified and under the conditions laid down in the directives and regulations relating to firms providing investment

[49] See article 33 draft MiFIR. The same provision in the last available Presidency compromise dated 3 December 2012 has not been modified.

services. In accordance with this, the draft MiFIR suggests to grant to ESMA the power, where it is satisfied on reasonable grounds that the conditions are fulfilled, to *temporarily* prohibit or restrict in the EU (a) the marketing, distribution or sale of certain financial instruments or financial instruments with certain features; or (b) a type of financial activity or practice.[50] A prohibition or restriction may apply in circumstances, or be subject to exceptions, specified by ESMA. ESMA shall only take a decision to prohibit or restrict if all of the following conditions are fulfilled: (a) the proposed action addresses a threat to investor protection or to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union; (b) regulatory requirements under European legislation that are applicable to the relevant financial instrument or activity do not address the threat; (c) a competent authority or competent authorities have not taken action to address the threat or actions that have been taken do not adequately address the threat. When taking action, ESMA shall take into account the extent to which the action: (a) does not have a detrimental effect on the efficiency of financial markets or on investors that is disproportionate to the benefits of the action; and (b) does not create a risk of regulatory arbitrage. Before deciding to take any action, ESMA shall notify competent authorities of the action it proposes. ESMA shall publish on its website notice of any decision to take any action. The notice shall specify details of the prohibition or restriction and specify a time after the publication of the notice from which the measures will take effect. As provided under ESMA Regulation, ESMA shall review a prohibition or restriction imposed at appropriate intervals and at least every three months. Potentially, the prohibition or restriction could last indefinitely if properly renewed. If the prohibition or restriction is not renewed after that three month period it shall expire. Action adopted by ESMA shall prevail over any previous action taken by a competent authority. The European Commission shall adopt by means of delegated acts measures specifying criteria and factors to be taken into account by ESMA in determining when the threats to investor protection or to the orderly functioning and integrity of financial markets and to the stability of the whole or part of the financial system of the Union arise.

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[50] Article 31 draft MiFIR. See the slightly modified provision in the last available Presidency compromise dated 3 December 2012.

The above indicates the potential for a much more interventionist approach at European level, which is a prospect that firms and trading venues are likely to view with some apprehension.

4. Complex **versus** *non-complex products*

"Non-complex" instruments currently include certain non-derivative instruments such as shares, bonds and UCITS products.[51] Under MiFID, firms are generally required to seek information from retail clients to determine whether the client has the knowledge and experience to understand the risks involved in the transaction or service being offered (known as the "appropriateness test"). No appropriateness test is required for sales of non-complex instruments.

As already mentioned, in the context of the MiFID Review, CESR (the predecessor of ESMA) consulted on a proposed analysis and interpretation of MiFID's distinction between complex and non-complex financial instruments for the purposes of MiFID's appropriateness requirements.[52] MiFID does not seek to provide definitive or complete lists of all types of products and how they should be categorised. Since MiFID was agreed, CESR and its members have received requests for clarification of how types of products might be categorised. CESR's work identified several weaknesses in the existing MiFID text. Consequently, CESR suggested in its technical advice to the European Commission amendments to clarify and to deliver a more graduated risk-based approach to the distinction between complex and non-complex financial instruments.[53] CESR advice was taken into account in the draft MiFID II.[54]

The new provisions of the draft MiFID II make more detailed specifications as to the types of instrument that would be regarded as non-complex. For instance, bonds and money market instruments must not incorporate a structure that makes it difficult to understand the risk involved; shares or units in UCITS are specified as non-complex but struc-

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51 Article 6 MiFID and article 39 MiFID Implementing Directive.

52 See CESR/10-417, *supra* note 40.

53 CESR/10-859, *supra* note 40.

54 See article 25.3 draft MiFID II. See the slightly modified provision in the last available Presidency compromise dated 3 December 2012.

tured UCITS[55] are expressly excluded. In the MiFID Consultation, a more draconian alternative of prohibiting execution-only sales was proposed, but this is not found in the draft MiFID II.

III. Product intervention at national level

Several Member States have recently adopted regulatory actions with respect to complex products.[56]

Most Member States analysed for the purposes of this paper seem to favour disclosure to regulate complex products.[57]

Only Belgium, France and the UK have adopted a more interventionist approach.

A. The Belgian moratorium and contemplated regulation on the distribution of structured products to retail investors

With its on-going moratorium and open consultation, which is now closed, and its forthcoming regulation, Belgium took the most interventionist approach among all Member States.

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55 As defined in article 36(1)(2) of EC, *Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website*, [2010] O.J., L 176/1.

56 See the interesting quote of Sheila Nicoll, in FSA, Sheila Nicoll, "Product intervention and European Union engagement: two key strands of our consumer protection strategy" (Speech delivered at the Christiansborg Palace, Copenhagen, Denmark, 25 January 2011): "This leads us to support minimum, rather than maximum, harmonising directives or regulations in the retail space[...] We have encountered a number of examples recently where we have identified a potential or growing risk posed to our retail market or something which a directive simply hasn't covered, but then find ourselves prevented from taking action or making the necessary rules because of the maximum harmonising nature of an existing directive."

57 See the Italian Consob notice no. 9019104 of 2 March 2009 on the intermediary's duty of correct and transparent conduct in the distribution of illiquid financial products; the Danish Executive Order no. 345 dated 15 April 2011 on risk-labelling of investment products; the Dutch legal framework on the "financiële bijsluiter"; and the German Gesetz zur Stärkung des Anlegerschutzes und Verbesserung der Funktionsfähigkeit des Kapitalmarktes (AnsFuG, April 2011).

On 20 June 2011, the Belgian Financial Services and Markets Authority ("FSMA") published a communication on a voluntary moratorium on distribution of certain complex structured products to retail clients (the "FSMA Communication").[58] On 29 July 2011, the FSMA published a list with institutions that have acceded to the moratorium as well as a Technical FAQ's ("Technical FAQ") further clarifying the scope of the moratorium (regularly updated). The FSMA also updated and amended the initial Communication. On 1 August 2011 the moratorium entered into force. On 12 August 2011, the FSMA published an open consultation (the "FSMA Consultation"), which closed on 15 October 2011. The FSMA Consultation was meant to inform a regulation (the "FSMA Regulation") which is still awaited.

The moratorium applies to the "distribution" by a "distributor" to "retail investors" of "structured products" that are deemed "particularly complex".

In its Technical FAQ, the FSMA expressly confirmed that the definition of "distribution" also includes private placements. Execution-only also appears to be fully covered by the notion "distribution". The exception for discretionary portfolio management is expressly mentioned in the Communication and the Technical FAQ, although it is not mentioned in the Consultation. This leads to uncertainty whether the FSMA wishes to abolish the exception for discretionary portfolio management.

"Distributors" include both Belgian and non-Belgian entities provided that they distribute products in Belgium, including credit institutions, investment firms, insurance companies, banking and investment intermediaries, insurance intermediaries, management companies of collective investment undertakings and issuers to the extent they market themselves structured products to retail investors.

There is however an opt-out, under certain conditions, for "retail investors" with moveable assets of at least 500,000 held with one institution. The opt-out is not a decision that a client can make on a case-by-case basis. The 500,000 limit for purposes of the application of the opt-out is determined per individual retail investor, and not per relationship (e.g., company, community of rights or matrimonial property). The sum is calculated per institution and not on the basis of the client's total assets. The

58 See the FSMA web-site for all the documents relating to the Belgian moratorium.

opt-out applies only to the portion of the assets that exceeds 500,000. But the 500,000 exception is not referred to in the FSMA Consultation.

"Structured products" are defined as any investment product, no matter its legal form, which includes one or more derivatives and the reimbursement or performance of which depends on the evolution of one or more underlying values, according to a pre-set formula. The FSMA Communication provides a list of non structured and structured products.

"Particularly complex" is defined in the FSMA Communication on the basis of a 4 prong test. If one of the 4 criteria is not satisfied, the structured product will be deemed to be particularly complex.

The FSMA Consultation introduces "product approval" as part of the proposed FSMA Regulation. The FSMA proposes that, prior to distribution of a structured product to retail investors, the distributor should carry out a product approval process. The responsibility for deciding whether the process has been adequately carried out should be with a product approval committee made up of members of senior management, in which at least the compliance and risk policy departments must be represented. Distributors may for some aspects of the process refer to information provided by the issuer or the entity responsible for the structuring. The distributor, however, has ultimate responsibility and must be in a position to verify, by itself or via an external provider, the information received. The FSMA Consultation proposes the following options in case of non-compliance by a distributor with the requirements of the FSMA Regulation: (i) a total ban on distribution of the structured product to retail investors; (ii) restrictions on distribution (e.g. only certain categories of retail investors based on their assets or knowledge); (iii) distribution with a warning in the marketing materials indicating that the structured product is not suitable for retail investors; and/or (iv) changing the product characteristics so that the product fulfils the criteria.

The FSMA received many responses to its Consultation from the industry, most of which oppose the suggested measures. There are many uncertain areas which need to be addressed to avoid legal uncertainty. Next to questions relating to the legal basis of such intervention and next to practical questions, there are many transition issues even though the FSMA has clearly stated that the moratorium applies to new structured products marketed as from 1 August 2011.

Most importantly for the purposes of this article, there seem to be incompatibilities with existing and forthcoming European laws.

As examined above, product intervention as such is foreseen in several pieces of European (draft) legislation. There are concerns about the compatibility of the FSMA moratorium and the contemplated intrusive measures under the FSMA Consultation with the relevant provisions of ESMA Regulation and MiFID dealing with product intervention.[59]

Besides, as retail investment services are subject to a number of European directives, many of which allow products to be distributed across Member States and are maximum harmonisation, one might question how these directives might interact with the contemplated FSMA Regulation. The Belgian regulator should be sure to correctly reconcile the contemplated measures with the UCITS directive,[60] the prospectus directive[61] and the AIFMD[62] as the case may be.

Next, one should be very cautious in order not to breach the principle of free movement of capital embedded in the EC Treaty to the extent the

59 See above.

60 Articles 91.1 (“UCITS host Member States shall ensure that UCITS are able to market their units within their territories upon notification in accordance with Article 93”) and 91.2 (“UCITS host Member States shall not impose any additional requirements or administrative procedures on UCITS as referred to in paragraph 1 in respect of the field governed by this Directive”) of UCITS IV.

61 It is likely incompatible with the maximum harmonization nature of the prospectus directive if non-Belgian issuers are discriminated if passported prospectuses cannot be used or if additional marketing requirements are requested.

62 See recital (71) of EC, *Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010*, [2011] O.J., L 174/1: “Member States should be able to allow the marketing of all or certain types of AIFs managed by AIFMs to retail investors in their territory. If a Member State allows the marketing of certain types of AIF, the Member State should make an assessment on a case-by-case basis to determine whether a specific AIF should be considered as a type of AIF which may be marketed to retail investors in its territory. Without prejudice to the application of other instruments of Union law, Member States should in such cases be able to impose stricter requirements on AIFs and AIFMs as a precondition for marketing to retail investors than is the case for AIFs marketed to professional investors in their territory, irrespective of whether such AIFs are marketed on a domestic or cross-border basis.”

contemplated provisions would result in increased costs or otherwise hinder access to the Belgian market.[63]

Lastly, as a more general remark, it is important to consider the competitive position of Belgian firms if Belgian regulation takes a more interventionist, product-based approach than other Member States. Besides, a strategy of product intervention which is superequivalent to new European measures (i.e., the application of the Belgian rules would go beyond that agreed in European directives) would damage the competitiveness of Belgian firms while leaving retail investors exposed to detriment from firms 'passporting-in' to the Belgian market. These concerns would make the case for lobbying for changes at European level rather than unilateral intervention within a single Member State.

In conclusion, some aspects of a product intervention approach are more appropriately addressed at European level.

B. The French *de facto* ban

In its publication of 15 October 2010,[64] the French *Autorité des Marchés Financiers* (AMF) explained its interpretation of the legal requirements applicable to the direct marketing of financial products which include risks that can hardly be understood by retail investors or which can be hard to understand and reminded distributors of their responsibilities (the Position).

If a French or a foreign structured UCITS or a complex debt security or equivalent foreign security is offered to the public,[65] if the protection offered at maturity is less than 90 % of the capital invested, and if it the financial product concerned falls within one of the following four categories (i) poor presentation of the product's risks and/or payoff profile, (ii) retail client's lack of familiarity with the underlying assets (iii) payoff profile that relies on simultaneous occurrence of several conditions across

[63] See article 56(1) of the EC Treaty. See also ECJ, *Commission of the European Communities v Kingdom of Belgium*, C-478/98, [2000] ECR I-07587.

[64] AMF, *Position AMF n° 2010-05: La commercialisation des instruments financiers complexes*.

[65] The Position states that it does not apply to the sale of financial instruments in response to a client's unsolicited request to purchase a specific instrument, portfolio management agreement or marketing to professional investors or eligible counterparties. It does not apply to ordinary warrants.

different asset classes; (iv) a number of mechanisms in the formula for calculating the financial instrument's payoff, the AMF states that it would be "particularly difficult" to comply with all applicable rules and regulations. Therefore, any advertisement relating to such product must include a specific risk warning along the following lines: "The prospectus relating to the complex debt instrument was approved by [regulator]. However, the AMF considers that the product is too complex to be marketed to retail investors and it has therefore not examined the marketing documents. Those marketing documents are published under the sole responsibility of [responsible entity"] or "The Ucits was approved by [regulator]. However, the AMF considers that the product is too complex to be marketed to retail investors and it has therefore not examined the marketing documents. Those marketing documents are published under the sole responsibility of [responsible entity"] (free translation).[66]

The only exception is where the financial instrument has a face value or initial subscription amount which is equal or more than 50,000 and the portfolio diversification is sufficient.

If the marketing relates to financial products concerned by the Position but if the protection offered at maturity is more than 90 % of the capital invested, and if it the financial product concerned does not fall within one of the above-mentioned four categories, or if the above-mentioned exception applies, then the risk warning shall not include any specific wording but shall only refer to the person responsible for the marketing material.

Some commentators have considered that this Position was a *de facto* ban on the marketing of the complex financial products concerned. Similar comments as those in the context of the Belgian rules discussed above apply. It can be added that the Position does not take into account the definition of complex products given by European instances. Contrary to

[66] "Le prospectus d'émission du titre de créance complexe proposé a été visé par [nom du régulateur]. Cependant, l'AMF considère que ce produit est trop complexe pour être commercialisé auprès des investisseurs non professionnels et n'a dès lors pas examiné les documents commerciaux. Ces supports sont établis par [nom(s) de la (ou des) entités responsables]" or "L'OPCVM proposé a été agréé par [nom du régulateur]. Cependant, l'AMF considère que ce produit est trop complexe pour être commercialisé auprès des investisseurs non professionnels et n'a dès lors pas examiné les documents commerciaux. Ces supports sont établis par [nom(s) de la (ou des) entités responsables]."

the Position, MiFID excludes from complex products structured UCITS and includes warrants.

C. The UK approach to product intervention

The UK regulator, including the Financial Services Authority (FSA), seems very active to improve investor protection, through initiatives such as the "Treating Customers Fairly" initiative (as from end of 2008),[67] the Retail Distribution Review[68] and the Mortgage Market Review which are key initiatives at the point-of-sale.

More recently, it considered that effective consumer protection cannot be achieved only through fair sales processes and transparent product disclosure.[69] The FSA submitted that it should focus on the earlier stages of the product life-cycle.

In its discussion paper on product intervention (the Discussion Paper), the FSA developed a new supervisory approach to scrutinising products and their governance as part of its adoption of intensive and intrusive supervision. Governance of a product means systems and controls in relation to product design, product management and distribution strategies.[70]

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67 *Inter alia*, FSA, *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers*, Discussion Paper No. 06/4, September 2006, and FSA, *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers*, Policy Statement No. 07/11, July 2007. See also, *Regulatory Guide*, annexed to Policy Statement No. 07/11; FSA, *Treating Customers Fairly and UK Authorized Collective Investment Schemes – Good Practice Illustrations*, January 2008; FSA, *Transparency as a Regulatory Tool*, Discussion Paper No 08/3, May 2008, at 49; FSA, *TCF Progress Report*, May 2007, at 2-3.

68 Initially proposed in FSA, *A Review of Retail Distribution*, Discussion Paper No. 07/1, June 2007. See the FSA website for latest documents.

69 See HM Treasury, *A new approach to financial regulation: building a stronger system*, February 2011 [HM Treasury]; Hector Sants, FSA Chief Executive, *FSA Business Plan 2011/12*, March 2011, at 12.

70 See in that respect the fine imposed in October 2011 by the FSA to Credit Suisse UK arm of £5.95m for selling £1bn in complex structured products to private banking clients without making sure the sales were suitable and properly explained. It is the third-largest fine issued by the FSA in 2011 and the highest for a failure of risk management systems alone. The case is a clear illustration of the FSA effort to make sure that UK investment firms keep regular track of customers' risk appetites and investment goals, and provide products that meet client needs.

The supervisory approach developed in the Discussion Paper is supported by the possibility to issue new product governance rules, including design, distribution channels and after-sale issues.[71] In that context, the FSA urged manufacturers of structured products in a guidance consultation relating to its Principles of Business to identify the target audience, to design the products to meet the target audience's needs, to stress-test new products, to ensure a robust product approval process for new products and to monitor the progress of a product over its lifetime.[72]

This new approach to regulation is in line with what the future Financial Conduct Authority (FCA) will do. Indeed, it has been said that the FCA needs to adopt a regulatory approach that involves earlier regulatory intervention and considers "product governance".

In the Discussion Paper, complexity is listed as "indicator of problematic product features". [73] When deciding which particular products to review, the FSA assesses the inherent risk posed to investors. It considers a range of factors including clarity of the product structure and product complexity, including the bundling of different types of products.[74] In its recent consultation on guidance relating to the FSA Principles of Business, the FSA cites as "actions for firms" the fact that "firms should decide whether their structured product is one where customers would be wise to seek advice. If a structured product has complex features which are difficult to explain to customers, firms should take particular care with the use of non-advised distribution."[75] It also stated that "firms should assess the nature and complexity of the product to determine the likely training needs and other support required by distributors. Complexity should be considered in relation to other retail products and solutions rather than to wholesale activity or structures."[76] "Firms should assess both the nature and complexity of a product, and the financial capability of its target market, to determine the likely information needs of consumers.

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71 FSA, *Product Intervention*, Discussion Paper 11/1, January 2011.

72 See FAS, *Guidance Consultation*, *supra* note 11 at 2. Responses to the consultation are due by 11 January 2012. In that context, the FSA said it already recruited staff with experience and expertise in product design. See also, FSA & Office of Fair Trading, *Payment Protection Products*, 2011.

73 See Discussion Paper, at 3.39.

74 See Discussion Paper, at 4.17.

75 See FAS, *Guidance Consultation*, *supra* note 11 at 23.

76 *Ibid*. at 26.

The more complex a product's structure and features are, the more difficult it is likely to be to explain in a financial promotion without risk of consumer misunderstanding".[77]

The FSA acknowledges that product complexity may either be a necessary feature to obtain benefits for the customer or an unnecessary complication, providing limited benefits.[78] Product banning is therefore only an option, one that the FSA might be willing to consider for products that have the potential to cause significant detriment.[79] The FSA is conscious that there could be disproportionate costs in taking an interventionist approach compared to the benefits achieved, which will be ultimately passed to investors.

Most responses to the Discussion Paper stressed the proportionate costs that could be associated with an interventionist approach compared to the benefits achieved, which will be ultimately passed to investors. Among the risks cited were the following: investors for whom the product is suitable could lose access to it; it might undermine the business models of some firms which were managing the product effectively; it may be difficult in practice to be certain that a product is properly categorised as 'bad'; and there may be an unintended consequence that firms become less willing to innovate generally.

Given the mitigated responses, the FSA pursued extended consultations before publishing its feedback statement relating to the consultation (the Feedback Statement).[80] It also recognised that more work needs to be done on how to apply its risk-based approach.[81] According to the Feedback Statement, banning products or mandating or banning product features and exclusions should be considered where products have the potential to cause significant detriment or where product features are causing detriment. These instances are likely to be relatively rare. By intervening earlier in the value chain, the regulator will be able to prevent investors' detriment before it crystallises, or limit it, rather than seeking ex post redress.

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77 *Ibid*. at 28.

78 See Discussion Paper, at 3.41.

79 See Discussion Paper, at 6.14.

80 FSA, *Product Intervention Feedback on DP 11/1*, FS 11/3, June 2011[FSA, FS 11/3].

81 *Ibid*. at 29.

CONCLUSIONS

The European Commission strongly believes in financial markets for retail investors' purposes.[82] It therefore continues to promote their use, notwithstanding the weaknesses of retail actors in financial markets, as most recently dramatically showed during the financial crisis. But, conscious of the risks financial markets constitute to high street investors, it constantly tries to refine its regulatory tools to achieve better investor protection.

This article is a reflection on the recent emphasis put by the European regulator on product intervention to address the various risks facing the retail investor. The European regulator thereby moves from disclosure and point-of-sale regulations to empowering the concerned authorities to intervene in the early stages in the process of designing, creating and selling a retail investment product.

As argued more at length in another piece which relies on empirical behavioural evidence,[83] disclosure should not be the preferred regulatory mechanism of the European Commission when intervening for retail investor protection purposes. This is due essentially to the lack of time and competence of those investors in financial markets.

The author believes that to protect retail investors in financial markets, regulatory emphasis should continue to be set at the level of the distribution chain. On the one hand, retail investors tend to rely heavily and passively on advice.[84] On the other hand, intermediaries are deemed to be professionals who have a full understanding of the products they distribute. This being said, the advice and sales rules embodied in MiFID did not prevent mis-selling to happen during the financial crisis. It is hoped that the modifications contemplated by the MiFID Review will contribute to solve persisting problems.

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82 See *the* PRIPs proposal, *supra* note 3 at 12.

83 See Gaëtane SCHAEKEN WILLEMAERS*, The EU Issuer-Disclosure Regime: Objectives and Proposals for Reform* (Alphen aan den Rijn, Netherlands: Wolters Kluwer Law & Business, 2011).

84 See Decision Technology Final Report, *supra* note 2 (concluding that "professional financial advice plays a key role in the market" (at 21) and emphasising processes of persuasion, importance of personal interaction and the role of trust in the advisor or salesperson (at 385 et seq)).

As effective investor protection is not achieved by fair sales processes and transparent product disclosure even though selling standards can often limit the harm caused to investors and despite monitoring and enforcement, disclosure and point-of-sale regulatory techniques could be complemented by increased product intervention to respond to innovation risks, as contemplated by the draft MiFID II and MiFIR and as illustrated by the various Member States' initiatives analysed above. Interesting to note is that the UK Treasury's recent consultation proposes that the FCA be given the power to ban products.[85]

However, one should be cautious in that respect. A more intrusive product design technique also carries considerable risks and should be well-thought from a costs-benefits perspective before enacting any rule thereunder. Regulation should always be proportionate and costs should never exceed benefits.

The boundary between investors' choice and protection is an ongoing debate to which there are no easy answers:

- By acting to increase investors' protection one may reduce choice. While all innovation and choice is not beneficial to investors, regulators must be careful before they act. Product intervention could stifle innovation and slow down product development. Investments inevitably involve risk. Complexity may be necessary for the product to function as expected and might answer the needs of specific investors. Structured products indicators are not absolute determinants of detriment.
- Another important element to the debate is investors' responsibility. Regulators must seek that a focus on product intervention does not lessen the importance of investors' responsibility.
- Product intervention implies that supervisory authorities have adequate resources to intervene early enough in the process. It also requires necessary competence to understand product governance issues. These requirements will result in additional costs.
- There is as well a risk of regulatory failure and over-regulation.
- Next, when poor decisions are made, it could be a result of lack of knowledge or information. Then educational campaigns to a cer-

85 HM Treasury, *supra* note 69 at 71.

tain extent,[86] pre-contractual information and suitable advice all constitute an appropriate remedy. But bad decisions could also reflect behavioural biases. This is an avenue of research which should be further investigated than it is now to design correct policy to protect investors.

- A last point to note is that when assessing product intervention initiatives at Member States' level, the European dimension should be taken into account. Product intervention seems best pursued at European level, rather than each Member State adopting a national approach which may be inconsistent with European developments. Besides, there is a risk of cross-border arbitrage if products originating outside the Member State, without similar rules, can be passported into that Member State, undermining the effectiveness of that Member State's product interventions. Unless the Member State's regulator can act against products originating outside the Member State, there is a risk that market failures will remain in spite of greater product intervention.[87] In addition, a Member State regulation should remain consistent with the approach adopted more widely in the EU in order to maintain its competitiveness.

This article agrees with Professor Moloney who suggests focussing on the product governance and the imposition of high-level design-process and disclosure obligations on the originator, rather than on a detailed product regulation. An appropriate retail product should be one in respect of which the risks of the product can be made clear, it is reasonably foreseeable how it will behave in conditions of market stress – which can be communicated in an understandable fashion to retail investors –, the structure of which can be compared to competitors' products and tests have been achieved on target groups in terms of communicating risks and the product's response to investor needs. Better targeted supervisory

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86 See Decision Technology Final Report, *supra* note 2 at 390 (acknowledging the lack of studies regarding if and to what extent it is possible to improve behavioural traits through education or information campaigns).

87 Note in that respect the French AMF Position stating that it applies even for passported products ("les communications et supports afférents aux instruments financiers concernés se rapportant à une offre au public ou à une admission aux négociations sur un marché réglementé, y compris lorsque le prospectus a fait l'objet d'une procédure de passeport, ainsi que les supports commerciaux afférents aux OPCVM à formule français et européens coordonnés doivent respecter, le cas échéant, les mentions figurant en annexe 1").

strategies are more likely to achieve investor protection than rigid and complex rules. Further to the UK example of Treating Customers Fairly, the European regulator should focus on the product originator and the product distributor responsibilities, including with respect to product design, stress testing, product testing and choice of distribution channel. Instead of focusing entirely on product structure, it should require product providers to consider whether a particular product, while UCITS-compliant for instance, reflects investor's demand and investor's competence. It should address the retail investor's weaknesses, including diversification problems and market risk. It should be responsible for its choice of the distribution channel so that distributors would know the products they advise or sell. One could set additional competence requirements for certain non-mainstream products, where detriment is likely if under-qualified advisers fail to account for risks they do not understand.[88]

In essence, what matters is whether the investor understands the risks and returns profile of the product, not its structuring.

[88] See FSA, FS 11/3, *supra* note 80 at 49.