Finance Watch

Making finance serve society

Towards suitable investment decisions?

Improving information disclosure for retail investors

A position paper on Key Information Documents for Investment Products

November 2012

Never invest in a business you cannot understand

– Warren Buffet

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Summary and recommendations:

This position paper is Finance Watch's response to the European Commission proposal on "Key Information Documents for Investment Products".[1]

This proposal will require that retail investors are shown a synthetic information document before purchasing so-called packaged investment products. Packaged investment products include investment funds, insurance products linked to financial markets and structured retail investment products.

The purpose of this proposal is to make information on investment products more intelligible and comparable for retail investors. Our main conclusions on the proposal are as follows:

1

The new Key Information Document might have a detrimental impact on other socially useful investments outside the scope.

To the extent that packaged products will be perceived as less complicated, they might attract previously reluctant investors hoping for excess return in a context of low interest rates. An unintended consequence might be to implicitly promote packaged products to the detriment of other socially useful investments that contribute to growth, employment, or the stable funding of loans, such as direct holdings of shares, bonds and bank deposits.

Recommendation 1:
Widen the scope of this regulation and further specify some terms in Article 2's exclusion list (see page 7).

2

Improving disclosure alone will not be enough to protect retail investors.

Improving information transparency is good but research shows that it will be not sufficient to enable retail investors to make suitable investment decisions because:

a. retail investors exhibit a low level of financial literacy,
b. many financial advisors do not understand all the risks involved in the products that they sell, while empirical evidence shows that retail investors rely heavily on advice,
c. behavioural economics shows that investors suffer from biases in their decision making and their financial capability is more influenced by psychological than informational factors,
d. there is a huge difference between understanding how a financial product works and being able to assess the risks attached.

3

Existing directive on UCITS investment funds includes product rules that should be adapted to all packaged products.

The new Key Information Document is adapted from the UCITS directive on investment funds. This directive also includes investment rules that limit eligible assets, use of derivative instruments etc. to ensure the suitability of investment products offered to investors.

These rules are an essential element of the soundness and success of UCITS and are all the more necessary in the wider context of packaged investment products. They should therefore be adapted and used in this area as well.

Recommendation 2:
Introduce product design rules adapted from UCITS to further protect investors and ensure the suitability of investment decisions.

1. European Commission (COM(2012) 352 final)

4 There is a political and societal dimension to retail savings.

The size of the EU packaged retail investment market is colossal at close to €9 trillion in 2009. In a context of strained public finances and the need for well-capitalised EU financial institutions and well-funded EU corporations, we need to think of where we want to incentivize retail savings. Some investments are socially useful as they not only offer good potential returns but also contribute to financing the real economy or supporting GDP and job creation in the European Union. Others are just bets with no economic value.

Recommendation 3:
Introduce a social usefulness dimension through disclosing amongst the ESG (environmental, social and corporate governance) objectives whether the financial product is an investment or a bet, and through excluding from eligible assets those with demonstrated adverse societal consequences.

5 Finding a comprehensive methodology to summarize all risks in a single indicator is unlikely.

The European Commission proposes to introduce a summary risk indicator that would give a risk grade to investment products. However finding a robust common methodology for all packaged products appears difficult. A summary indicator including only some of the risks could be more misleading than useful.

6 A risk indicator in a grade format may have a detrimental psychological impact,

as investors are likely to focus unduly on it and pay less attention to the accompanying narrative explanation of other risks.

Such an indicator might also give an illusion of simplicity and comparability, whereas it would not provide for better understanding but instead rely on a methodology that investors do not understand.

7 The crisis has shown that the overreliance on external risk indicators in a grade format such as ratings was not desirable.

Introducing a new indicator of a similar format might not be consistent with the objective of reducing overreliance on external ratings in EU regulation.

Recommendations 4 and 5:
Remove the summary risk indicator and replace it by a multifactor scenario analysis.

8 The multitude of ESG principles and norms creates a risk of "greenwashing" and box-ticking.

The text proposes to disclose the environmental, social and corporate governance (ESG) objectives of the investment products. It does not, however, specify the criteria or the principles to be used. As there is a vast number of socially responsible standards of varying strictness and no internationally agreed framework, failure to propose sound standards might lead to "greenwashing".

9 Fees are only the visible part of the costs of structured products:

other costs are embedded during the structuring phase of the product. These costs are not paid upfront but financed through additional risk taking by investors. As they reduce investors' potential returns on their investment we believe that they should be disclosed in a transparent manner.

Recommendation 6:
Request the disclosure of the theoretical margin at maturity of structured products.

Introduction

Does product choice really benefit investors?

The current context for retail investors exhibits two diverging trends: on the one hand, the financial crisis led to a collapse in investor confidence in financial products and the market in general, partly as a result of investments not performing as expected and not being fully understood. On the other hand retail investors are being offered a wider than ever choice of investments.

While this situation raises the obvious issue of restoring confidence and addressing the underlying causes of the current mistrust, such as lack of transparency and understanding, it also provides an excellent opportunity to pause for a moment and ask ourselves more fundamental questions.

There is a political dimension to retail savings

One of the questions could be about the extent to which retail investors and society really benefit from the dizzying choice of financial instruments: do they provide consistently superior returns over the long run, less volatile returns, more growth? Are investors making more informed investment decisions? Or alternatively is this leading to more mis-selling and risk transfers to households? A recent study commissioned by the European Commission concluded that 57% of investment recommendations were broadly unsuitable.[2]

The size of the packaged retail investment products market in the EU is considerable with nine trillion euros invested in packaged products in 2009 according to the European Commission impact study.[3] At a time where public finances are strained, financial institutions are looking for more stable funding and well-funded EU start-up companies are vital, there might also be the political and societal question of where we want to incentivize savings.

Will better disclosure be enough?

Improving transparency and levelling the playing field between financial instruments of different legal formats are very good and necessary objectives and we welcome the Commission's proposal on Key Information Documents for Investment Products sold to retail investors. However we feel that these are not the only dimensions that should be considered when discussing PRIPS,[4] and want to be cautious not to create unintended consequences.

Warren Buffet once said that you should never invest in something you cannot understand. At a time where products are getting more complex and their availability to retail investors is getting easier, while financial advisors are not necessarily getting more training, it might be worth remembering this simple wisdom.

2 Synovate 'Consumer market study on advice within the area of retail investment services' (2011)
57% represents roughly a staggering EUR 5 trillion of investment products mis-selling.

3 European Commission Impact Assessment on key information documents (SWD(2012)187)

4 For fluency of reading, when mentioning the new regulation proposal, we will use the old acronym PRIPS even though the name of the legislative text has changed

I. Are we asking all the right questions?

A. Scope and possible unintended consequences

The Key Information Document is adapted from UCITS

We generally welcome the Commission's proposal and fully support its objectives.

As a reminder the text proposes the introduction of a short synthetic information document on investment products sold to retail investors, in order to make information disclosure more intelligible and comparable. This Key Information Document is adapted from the existing Key Investor Information Document (KIID) in the UCITS directive.

The scope of the proposal encompasses UCITS and non-UCITS funds, unit-linked insurance and retail structured products.

According to the impact assessment report, in 2009 UCITS funds represented 58% of the scope, non-UCITS funds 18%, unit-linked insurance 19% and retail structured products 5%.

The overarching aim of this proposal is to improve the suitability of retail investors' investment decisions, which we understand as meaning that retail investors should not be surprised by future returns and potential losses as they will have understood the risks involved when they made their investment choices.

Retail investors should not be surprised by future returns

This contributes to some extent to improving retail investors' ability to build up long term savings but is not the same thing: investing involves risks and improving disclosure will not necessarily improve long term average returns for retail investors but merely ensure that negative returns come as less of a surprise.

We have some concerns regarding the impact of the new text on financial instruments that are outside of its scope. If the Key Information Document is successful, and we have every reason to believe it will be considering the success of the UCITS KIID, then it is likely to implicitly promote packaged investment products to retail customers: insofar as packaged products will be perceived as less complicated and more comparable, previously reluctant investors looking for excess return might become more inclined to invest in these products.

This might lead to a decline in bank deposits and saving accounts and in direct holdings of stocks and bonds, all the more than their information documents exhibit a different "look and feel" that would not foster comparability.

It is fundamental to ensure that direct holdings of stocks and bonds remain attractive to retail customers, as these investments are potentially longer term holdings than indirect ones: the underlying investments of indirect holdings through funds are indeed often constrained in terms of maturity by the measurement of fund management performance and remuneration structure over short time scales,[5] which can incentivize

5 *"The tyranny of the benchmark has created an environment where fund managers are less inclined to back businesses or industries for the long-term because they are concerned with the career risk of moving too far away from their benchmark index over shorter time periods."* Kay Review interim report (Feb 2012)

asset managers to focus on assets with a potential for short term profit as opposed to purchasing assets with a potential for long term growth.

We must make sure that the proposal does not penalize socially useful investment outside the scope

As the value of long term investment is widely acknowledged, we must ensure that direct holdings of stocks and bonds are not penalized by the proposal.[6] There might thus be a case for including them inside the scope for comparability and psychological purposes.

Likewise, bank deposits and savings accounts contribute to the stable funding of loans and it is thus even more crucial to ensure that they remain attractive to investors.

We express some caution as well regarding some wording in the definition: we wish that the text were more specific when it excludes from the scope "*deposits with a rate of return that is determined in relation to an interest rate*". There are indeed several interest rate benchmarks that can be difficult to understand for retail investors, for example CMS10[7] or other long term benchmarks. We hope that retail products whose return is indexed on anything other than short term Eurozone reference rates will be inside the scope of PRIPS.

We hope as well that investment products whose return is linked to foreign interest rates or to euribor / libor but with an algorithmic payoff formula (e.g. 5 x euribor - 2%) will fall inside the scope.

Occupational pension schemes should be included

Some stakeholders argue, and we agree, that occupational pension schemes should be within the scope of the proposal even though they are not sold directly to retail customers, as the corporations purchasing them on behalf of their employees do not always employ investment professionals, typically in the case of SMEs.

Last but not least, we are concerned about the plain exclusion of the scope of direct holdings of "*other securities which do not embed a derivative*" without any further specifications. Securities do not have to embed derivatives to offer complex risk profiles or transfer unsuitable risks to investors, as they can replicate in their contract terms any derivative instrument.

Shares of special purpose vehicles are also securities which do not embed derivatives even though the SPV might invest in derivatives. It might thus be necessary to tighten the definition by listing the type of securities excluded.

B. Improved disclosure is only one dimension – shouldn't we be more ambitious?

The European Commission was requested in 2007 to examine the coherence of EU law for retail investment products and noted as a result of its investigation two areas where further work was needed: rules applying to sales and rules on product disclosure.

The first area will be addressed in MiFID2 and IMD[8] and the second one through PRIPS.

Sales and disclosure rules are not the only dimensions

We fully appreciate the need for regulation in these two areas but wonder whether sales practices and disclosure really are the only areas that need to be addressed.

Are there not any other dimensions that need to be taken into consideration when trying to improve retail investors' ability to make informed investment decisions?

A look at MiFID2 might give us some insights as to what these other dimensions could be: one of the core principles of MiFID1 was indeed that investors should understand what they invest in, in order to avoid mis-selling. MiFID actually included two specific

6 Although admittedly purchases of stocks and bonds on the secondary market do not directly fund companies. The Synovate (2011) market study also shows that stocks are currently being recommended by advisors only in 0.7% of cases.

7 10 years constant maturity swap

8 The Review of the Markets in Financial Instruments Directive (MiFID2), and the Insurance Mediation Directive (IMD)

articles, Article 35.1.c ensuring suitability of the sales transactions, and Article 36, ensuring their appropriateness.

Building on this, we feel that it is important to ensure that PRIPS does not fail to ask the more fundamental preliminary questions, before addressing the identified issues.

i. Social usefulness

As a recent Centre for European Policy Studies report[9] noted, asset management regulation may have other public policy objectives beyond financial stability, investor protection and fostering capital markets.

Investments should finance the real economy, creating jobs and growth

The difficult economic context and the PRIPS legislation provide in this respect a very good opportunity to think of the societal dimension of savings and investments and to promote investments that not only offer good potential returns, but also have the additional benefit of financing the real economy and supporting GDP creation and employment in the European Union. Member States already use differential tax treatments to direct flows of savings towards particular product types such as retirement and life insurance products.

Typically, investments in assets such as EU corporate stocks and bonds, EU sovereign bonds, private equity and venture capital are assumed to provide societal benefits, and all the more so if the investment style is long term: investing over full business cycles in companies and institutions that one likes and understands. Likewise, investments in bank deposits and saving accounts contribute to the stable funding of loans and are therefore socially useful.

This type of investment is not new at all, and is actually what traditional asset management is about. However, at a time of staggering growth in the volume of alternative investments and structured products being sold, it might be worth remembering what we really want and need.

One can similarly question whether assets such as agricultural commodity derivatives are socially desirable, since such assets are not investments but rather bets that do not provide any financing to the real economy and contribute to increasing volatility.[10]

We should question whether 'absolute return' products benefit the economy

We should also question whether absolute return investments[11] are socially desirable and whether we should facilitate their access to retail investors. Admittedly in times of crisis they might outperform long only products, however what is the actual evidence that they provide significantly higher returns over the long run than other types of investments? Moreover absolute return funds' activity is by nature about betting on short term price movements (whether upwards or downwards) as opposed to investing in long term assets that contribute to financing the economy. And insofar as such investments might exacerbate downward price spirals in times of crisis, we might question their usefulness from a society point of view.

As an example, a leveraged put on gold,[12] as was offered recently to retail investors in one EU Member State, is really just a high risk bet that does not finance anything: no company or project gets more funding as a result of this so-called investment, no job is created except perhaps at the broker selling it. This is really just a lottery ticket, only less useful from a society point of view as the tax rate is lower.

Also from a retail investor perspective, one might wonder how much choice really benefits them. Stating for example that retail investment products are "*essential for meeting the needs of EU citizens for products with which to build up savings and*

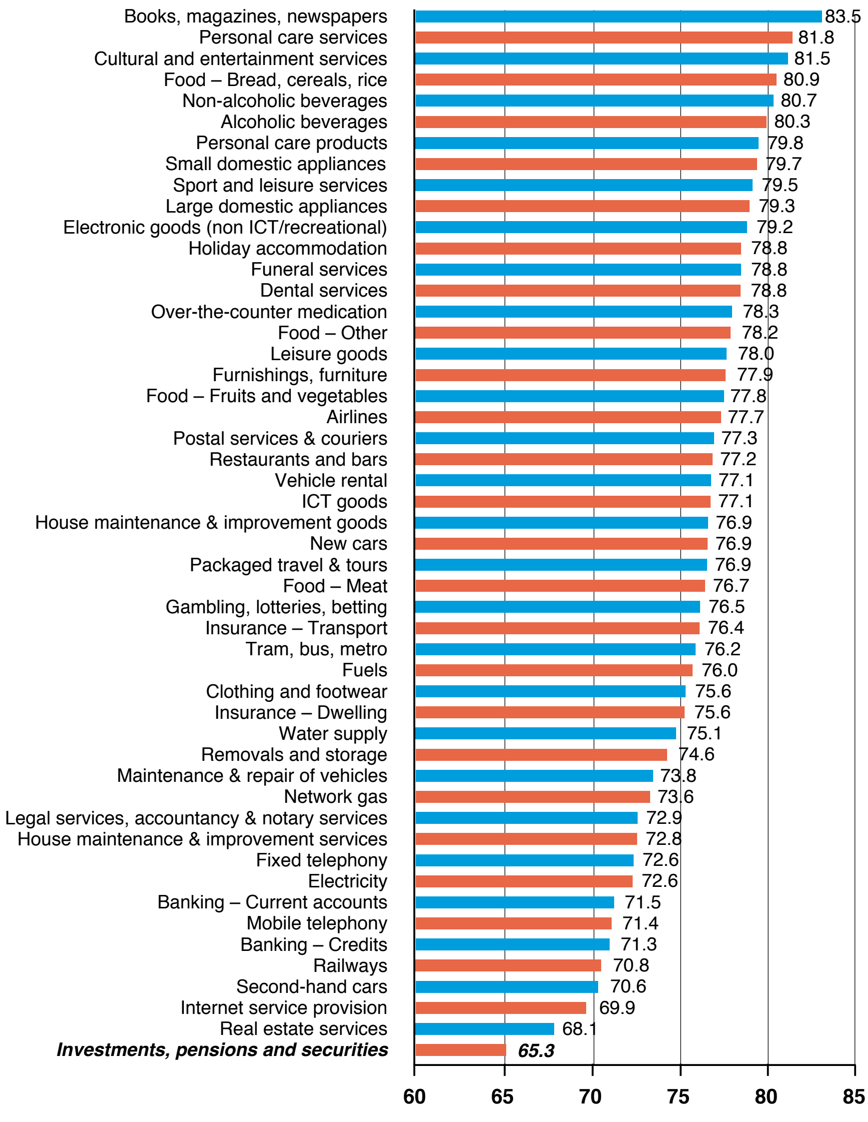
9 CEPS 'Rethinking Asset Management' (2012)
10 Finance Watch 'Investing not Betting' (2012), Section IV
11 See glossary
12 A product where your return is linked to a potential future decline in the gold price, see 'Turbos illimités' Commerzbank

investments" can give the misleading impression that all retail investment products, including highly structured products are equally essential for EU citizens, which would be debatable.

While there is no question about the benefit to citizens of affordable and fair access to the major asset classes such as stocks, bonds and money market, what are the real additional benefits for them of investing in other asset classes or in instruments with highly structured payoffs?

Some features provide benefits such as effective capital protection, but some other strategies are more dubious, unless we think that retail investors really have a view on correlation, volatility, convexity[13] and other highly technical risk measures.

Figure 1: EU consumer satisfaction per sector



Based on EU-wide consumer survey findings relating to comparability, problems & complaints, trust and satisfaction. Source: Consumer Markets Scorecard

The Key Information Document should state whether the financial product is a bet or an investment

One possible way to integrate the social usefulness dimension into the decision making process of retail investors could be to disclose in the ESG[14] objectives section of the Key Information Document what the investment ultimately finances and whether the

13 See glossary
14 Environmental, Social and corporate Governance

financial product is a bet or an investment.[15] As an example, financial products linked to inflation or currency performances are bets (except foreign direct investments) and financial products invested in stocks or bonds are investments.

Socially detrimental products should be excluded

In addition, introducing eligibility criteria on assets as is done within UCITS, might be an effective way to ensure that investment products that are socially detrimental are not promoted towards retail customers.

ii. Suitability

In order to put in perspective the potential impact of the proposed improved transparency on retail investors decisions, we should think about the four following findings:

1. An earlier Commission impact assessment[16] study noted that retail investors "*typically exhibit a low level of financial sophistication*" and "*are ill-equipped to assess the relative merits of the products on offer*". The Centre for European Political Studies also found empirical evidence that "most clients lack the knowledge to understand the risks involved in financial products" and "have difficulties understanding the concept behind strategies and risks."[17]

Many advisors do not understand all of the risks

2. As early as 2007 the UK Financial Service Authority noticed that many advisors do not understand the risks in the products that they sell,[18] while empirical evidence[19] and behavioural studies[20] showed that retail investors rely heavily on advice and are vulnerable to persuasion.

Retail investors' psychological attributes matter more than information

3. Behavioural economics has demonstrated that investors exhibit cognitive biases in decision making,[21] such as loss aversion,[22] anchoring and framing. Heuristics, or "rules of thumb", also play a role: for example, it is well known by sales people around the world that dry factual information has very little influence on behaviour; if you want to convince people, you have to wrap the facts in a story that appeals to the emotional side.[23] A recent study found in addition that "*ordinary biases in decision making are exacerbated by the specific characteristics of financial products but some of these biases persist even in financially literate subjects since they are closely related to psychological factors*".[24] The study measured financial behaviour in five areas, including choosing investment products, and concluded that "*psychological rather than informational differences may explain much of the variation in financial capability (..) and people's financial behaviour may primarily depend on their intrinsic psychological attributes rather than information or skills*".

15 See page 20 below for definition. For further details on the confusion around the definition of the word "investment", see Finance Watch 'Investing not Betting' (2012), Section I
16 European Commission 'Impact Assessment on Packaged Retail Investment Products' (2009)
17 CEPS 'Rethinking Asset Management' (2012)
18 FSA 'A Review of Retail Distribution' (2007)
19 CEPS 'Rethinking Asset Management' (2012)
20 *17% of purchasers stated that their choice was mostly or entirely based on their advisor's recommendation, More than 80% of purchasers completely or mostly trusted the advice they received* Chater et al (2010)
21 Tversky and Kahneman (1974) and Chater et al (2010)
22 See glossary for definitions of anchoring, framing, loss aversion and heuristics
23 As per the affect heuristic. Evidence shows also that "people are much more receptive to anecdotes and personal testimonials than they are to statistics" (US Social Security Administration, 'The Role of Behavioral Economics and Behavioral Decision Making in Americans' (2010))
24 FSA 'Financial Capability: A Behavioural Economics Perspective' (2008)

The main behavioural factors influencing retail investment choices, in approximate order of importance, are:

1. Cognitive limitations – consumers struggle with even very simple investment choices, especially if older or less educated.
2. Trust in advice – advice is ubiquitous in the retail investment services market and consumers are usually (and sometimes naïvely) trusting of advice they receive.
3. Attitudes to risk and ambiguity – investment choices are strongly influenced by perceived risk in investment returns or product complexity.
4. Framing effects – cognitively-limited consumers make worse decisions when investments are framed in harder-to-understand ways.
5. Familiarity and other heuristics – in the absence of advice, consumers may fall back on other (inappropriate) heuristics when making a choice.

Source: Chater et al (2010)

Understanding how a product works is not the same as being able to assess the risks

4. Finally and related to the point above, there is a huge difference between understanding how a financial product works and being able to assess the risks attached and their probability of occurring: let's take for example a fictitious 10 year investment where your annual return will be 4% the first 2 years, then for the following years 3% minus 5 times the difference between the 10 years mortgage rate and the 30 years mortgage rate if this difference is positive.
   You understand intellectually the mechanism: you have a return above current market conditions during the first 2 years, and still a fairly attractive return the following years, provided that the 30 years mortgage rate remains at all times above the 10 years mortgage rate. If not, then your return starts to decline and might even become negative.
   Yet you have no idea of the probability of having a good return on average on your investment nor do you have any clue of what your worst case scenario is.
   Even a historical chart showing you that over the past ten years, the 30 years mortgage rate was above the 10 years mortgage rate 95% of the time would not significantly increase your ability to assess the risks and reasonably get a sense of your future returns. If anything such as chart might be misleading because of the short sample period and as per the well-known adage that past performance does not reflect future performance. Even professional investors sometimes struggle with this issue, and often it's only once an investor has been "hurt" that he fully understands the risks.[25]

Building on these four elements, it seems fair to say that improving disclosure alone is unlikely to significantly enhance the actual ability of retail investors to make informed and suitable investment decisions, which is the end purpose.

Complementary measures outside of the scope of this proposal, such as improving financial literacy, addressing conflicts of interest in sales practices, testing clients' knowledge and improving sales force training, are also essential, even though they do not address the last two issues mentioned above.

Disclosure is not enough to protect retail investors

The Commission's impact study itself notes that "*proposals for improving product disclosure face certain important limitations in regards their direct capacity to improve investor decision making…In practice consumer protection measures in the retail investment markets must be understood in a holistic manner: a variety of tools (product*

25 Also see Tversky and Kahneman (1974) on the salience bias when assessing probabilities.

regulation, (..) conflicts of interest requirements (..), and improvements in financial education and capability amongst retail customers) are important and support one another.”[26]

Figure 2: Reasons given for choosing a retail investment product

Reasons for Choice	1st	2nd	3rd	Any
It seemed to me the safest out of all those available	35%	15%	13%	**62%**
It was the option that offered the highest return	13%	16%	13%	**41%**
It was the option recommended by a financial advisor	12%	10%	9%	**31%**
It was the option I was most familiar with	12%	16%	9%	**37%**
It was the option recommended by my bank or other financial company	9%	9%	9%	**26%**
It was the option recommended by a family member of friend	6%	8%	6%	**19%**
It was the first option I looked at	4%	5%	6%	**16%**
It was the option recommended by my employer	3%	2%	3%	**7%**
It was the option recommended in a report I read or saw in the media	2%	4%	5%	**11%**
It was the option recommended by a salesperson	2%	2%	3%	**7%**
Other	4%	2%	6%	**12%**

Source: Chater et al (2010)

Consequently this raises the question of the suitability of the products sold in order to further reduce the risk of mis-selling; some directions such as direct product regulation need to be considered in our view to further strengthen product integrity and to compensate for biases in decision making and low financial literacy.

The question of suitability has been raised recently by the European Securities and Markets Authority (ESMA), which would favour rules ensuring the suitability of new products being launched[27] and agreed with the other European Supervisory Authorities in a recent meeting that the Joint Committee would develop by 2014 a set of “high level principles” to push for rules forcing financial institutions to subject new financial products to risk-analysis before their launch to ensure they are suitable for retail consumers.

Similarly, and even though it finally abandoned its idea of pre-approving financial products for lack of resources, the UK Financial Services Authority had concluded in a recent discussion paper about product intervention that regulating selling practices and product disclosure was not sufficient to achieve the desired level of consumer protection and that product design rules were necessary:

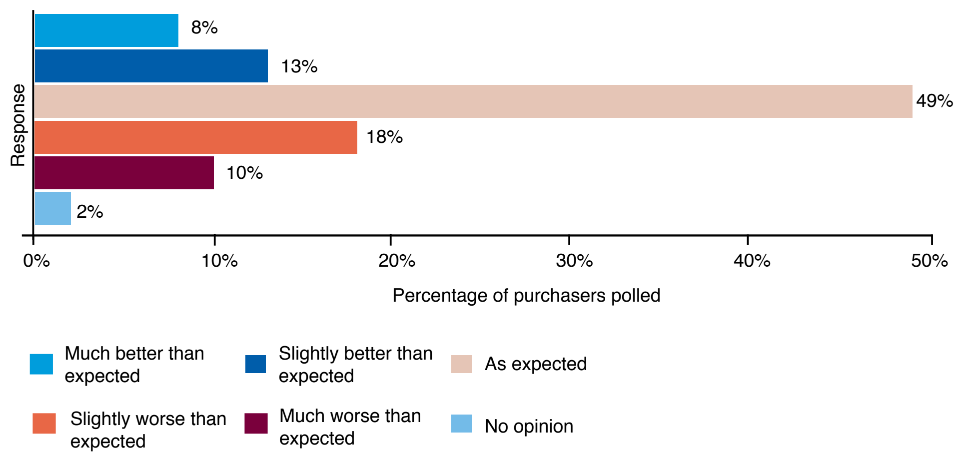
26 European Commission Impact Assessment on key information documents (SWD(2012)187)
27 MLex, ‘ESAs seek greater consumer checks on financial products’, 17 April 2012

"When product design was left only to the market some consumers suffered significant detriment"

"Our general philosophy has previously been to accept that most retail financial products are suitable for some consumers and so we should not intervene in their design. We saw it as our role to make rules and supervise the market at the point-of-sale to stop products reaching the wrong consumers, rather than questioning their design. So, while we have made clear that firms have responsibilities to design products appropriate to the needs of the intended target market, we have in practice focused on the point-of-sale – including financial promotions, product disclosure and selling practices – to try to prevent missales. This approach has not always achieved the right customer outcomes: in some high-profile cases, consumers have suffered significant detriment. We believe a new regulatory approach is needed to avoid these large-scale episodes of consumer detriment"… "In some circumstances (…) it may be more appropriate for us to intervene in the market to influence the design and customer segment targeting of products".[28]

Figure 3: Survey of retail investor satisfaction after making their purchase

28% of investments are rated as performing below expectations



Source: Chater et al (2010)

Finally, as the Key Information Documents for Investment Products proposal is essentially an extension of UCITS' KIID to other investment products, we wonder about the selective legacy: why transpose only the KIID and not UCITS' investment rules? UCITS includes specific requirements on eligible assets, eligible markets, liquidity, use of derivatives and others, designed to limit the potential risks of the funds and protect investors.

The 2009 impact assessment accompanying the communication from the Commission on PRIPS explained that:

"One regulatory approach is to target the product itself, by limiting the access of retail investors to certain product types or directly regulating the characteristics of the products (known as 'product regulation'). While this is one of the approaches adopted in the UCITS Directive, it is not a widely employed regulatory technique. The practical challenges associated with harmonising product features for all product types would be immense and the net market outcomes deleterious, particularly through the impact of such restrictions on product competition,

28 FSA 'Product Intervention' (2011)

diversity and innovation. This approach is not considered to be within the scope of this investigation".[29]

We would argue that this is not an insurmountable challenge and believe that simple effective rules can be designed, building on the UCITS framework.

We also strongly disagree with the alleged negative consequences on product competition, diversity and innovation: setting requirements to ensure that the investment products offered to retail clients do not carry excessive and unsuitable amounts of risk would not reduce diversity and innovation, but merely ensure that this diversity and innovation are suitable and beneficial for the customer. To quote a recent report from the FSA "*We still want to see innovation, but only where it is in the interests of consumers*".[30]

Hedge funds and other professional investors tend to avoid structured products. What does this tell us?

As for competition, the worldwide success of the UCITS brand in the funds universe despite its investment rules is the best answer to these alleged concerns.

Incidentally and to put things in perspective we find it interesting to note that most hedge funds and real money funds prefer to trade mostly in plain vanilla instruments, and rarely in structured products. The reason is that they find that they can express most of their market views with basic instruments, and these instruments have lower transaction costs and are more liquid. Consequently is it really credible that retail investors would find themselves too limited by basic instruments that are good enough for seasoned professionals?

Figure 4: Where problems can occur in the product life cycle

Problems	Exploitative pricing and design features, disregard of how products might behave, unfair contract terms	Exploitation of consumer behavioural traits (risk appetite, inertia)	Misalignment of firm and consumer interests leading to: Unsuitable advice Mis-selling	Unclear responsibility post-sales Lack of information on product performance or review of appropriateness in changing scenarios Churning/lack of persistency Lack of continuing consumer care Further unsuitable sales to "correct problems"
	Development	Distribution strategies	Point-of-sale	Post-sales handling

Source: FSA 'Product Intervention' (2011)

And let's remember that investment funds seek to maximise their return and would be very unlikely to avoid structured products if they felt that these offered superior returns on average.

It is crucial to address the question of suitability for retail investors

A textbook example of unsuitability is the case of French municipalities which up until recently were not included in MIFID's retail client category and have been sold all manner of toxic structured investments, leading to several French cities nearly defaulting and having to raise local taxes dramatically.

These included structured loan products with a low fixed rate in the first years that switched to a rate set by a formula linking it to interest rates, currencies and commodities, sometimes with highly leveraged and exotic payoff structures.

As much as they understood that the lower initial rate was gained at the cost of future risk and even when they fully understood the products features, municipalities were in most cases unable to assess the probability of getting into trouble nor the extent of the

29 European Commission COM(2009) 204
30 FSA 'Product Intervention' (2011)

potential losses they could face. Add to that some irrational but very human factors, such as the desire to feel smart and "beat the market" during the first years and the empathy relationship with the salesperson, and you had a recipe for disaster that no disclosure could have entirely prevented.

Based on the above, we conclude that it is crucial to address the question of suitability within the current proposal if we want significantly to improve retail investors' ability to make more suitable investment decisions.

C. Eligibility criteria framework proposal

Extend UCITS investment rules to packaged investment products

Building on this recommendation, we feel that disclosure and sales practices rules should be complemented in the current proposal by direct product regulation to further strengthen product integrity and investor protection.

A fairly sound framework already exists for 58% of the current proposal's scope, namely UCITS funds. Thus, rather than create a new framework, we propose to adapt and extend the scope of the UCITS framework and add two additional rules, one of which is targeted at specific categories of PRIPS products. This would be consistent with the European Commission's targeted standardisation approach.

Incidentally, as retail investment products issues are not just about disclosure, we feel that the proposal should go back to its original name PRIPS or be renamed Retail Investment Products instead of the less ambitious "Key Information Documents for Investment Products".

Apply UCITS investment rules to PRIPS

Just as the KIID has been extended to the PRIPS universe, we propose to adapt and extend the scope of UCITS investment policies obligations to the PRIPS universe, specifically Articles 49 to 57.[31]

We propose that these rules be dynamic and be revised if and when UCITS investment rules are reviewed.

Additional and related guidance such as ESMA's guidelines[32] on the calculation of global exposure and counterparty risk should be applied to the PRIPS universe as well.

As these guidelines put a cap on the amount of risk that UCITS funds are allowed to take, they are fundamental for investor protection purposes. Depending on the methodology used, the guidelines either cap the leverage of the fund at 2x its net asset value or cap the fund risk exposure measured by its Value-at-Risk over one month at 20% of its net asset value. The latter means that in a catastrophe scenario, an investor can expect to lose up to 20% of his investment over the course of one month 99% of the time, and lose more than 20% 1% of the time.

Incidentally, we wonder about the inconsistency between UCITS borrowing rules allowing only temporary borrowing up to 10% and ESMA's leverage guidelines limiting leverage at 2x.

Amend one article and add two additional rules

In designing these tentative additional rules we followed the overarching aim of ensuring that retail investors understand what they invest in, defined as investors not having negative surprises or unexpected losses post-trade.

A balance between freedom and protecting the vulnerable

The question of where to draw the line is difficult and is comparable to that of gambling or tobacco where a balance must be achieved between freedom, individual responsibility and one of law's core purposes of protecting the vulnerable. We have

31 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF

32 CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (2010)

chosen a soft approach that would enable people to invest as they like, as long as their investments:

1. have no demonstrated adverse societal consequences, and
2. do not have exceedingly non-linear risk and reward profiles and complex risk exposures.

We have thus focussed on ensuring that possible exposures are not too exotic, but suggest leaving in the scope those exposures where we are not convinced that retail investors have the ability to form educated opinions (i.e. curve trades, spreads), as long as their loss potential is reasonably linear. We also suggest leaving inside the scope underlying assets that are not investments as long as they don't have a demonstrated negative impact on society, such as so-called investments in currencies.

(i) Amend UCITS Article 50 on eligible assets:

We propose to generally follow the UCITS list of eligible assets and markets while seeking to ensure that indirect exposure cannot be gained to non-eligible assets. We propose to:

Ensure no exposure to non-eligible assets

1. Remove from the definition of transferable securities those in Article 2(2)(c) of Directive 2007/16/EC, as this Article mentions financial instruments linked to the performance of non-eligible assets.
2. Tighten the definition of indices to ensure again that they do not allow exposure to non-eligible assets through their underlying components.
3. Remove the possibility to invest up to 10% in transferable securities and money market instruments other than those referred to in UCITS Article 50 paragraph 1, as we feel that the rule on eligible assets should be enforced without exception.

(ii) Introduce a sub-rule relating to derivatives:

Setting eligibility criteria on the type of derivative instrument that can be used is in our view necessary, together with rules on payoffs[33] to ensure that the risk and reward profiles of the investment products are understandable by retail investors.

No overly complex derivatives

We would propose limiting eligible derivatives to simple swaps, futures, forwards and basic options, as well as simple barrier options and average rate options[34]. This range of instruments and their possible combinations offer a very wide range of structures enabling investors to express most simple market views.

More complex derivatives such as structured barriers and path-dependent derivative instruments[35] should, in our view, not be allowed as they create more complex risk exposures and require more than a basic knowledge to understand.

As an example, path-dependent derivatives are financial instruments whose return is linked not only to the value at maturity of the underlying asset but also to its value at different points in time (different "paths" leading to different returns[36]). Thus, using such instruments requires the investor to have a market view not only on the general direction of the underlying asset but also on its value at several points in time, a substantially more difficult task.

33 By payoff we mean risk and reward profile
34 See glossary
35 Except simple barrier options and Asian options
36 As in the case of products whose return is linked to the number of days that a stock index fixes above a specific level over the coming years.

(iii) Introduce a rule on payoff structures for structured products:

The purpose of this rule would be to prevent structured products with exceedingly non-linear payoffs and overly complex risk factors from being offered to retail investors, for suitability reasons.

No teaser rates or conditional principal protection

We would allow directional[37] exposure to one or more eligible assets, possibly combined as simple spreads or basic baskets.

As detailed in the Annex, we suggest excluding a number of payoff features that in our view are unsuitable for retail investors, such as conditional or capped principal protection, temporarily enhanced returns, conditional extension of maturity, and structured baskets.

Structured baskets such as "Himalaya" products, for example, are too complex to be suitable, in our view. A "Himalaya" is a financial product linked to a basket of stocks, where your return for the first year is that of the best performing stock in the basket. The stock is then removed from the basket. In the second year, your return is that of the best performing remaining stock in the basket, that is then also removed from the basket, and the same goes on every year until maturity.

This product is essentially a bet on stock market correlation: if for example all the stocks in your basket are telecom stocks, then they are likely to perform in a similar manner and "picking the winner" will not add much value. If however the stocks in your basket are from varied industrial sectors, from oil companies to luxury brands and utilities, they are likely to have diverging performances and the chances are that no matter what the economic context is, at least one will outperform the others and your potential return will be higher: the less correlated the stocks in the basket, the higher the potential return. In fact, purchasing this product is equivalent to betting that the correlation between the stocks in your basket will decline in the future.

Yet what is the likelihood that a retail investor like my grandmother ever understands such a product and the underlying bet she would be making? It seems fair to say extremely low. If she trusts her bank advisor, she is then likely to listen to his advice. However, even in the absence of conflicts of interests, what is the likelihood again that a client advisor with a bachelor degree and a few weeks of training understands himself a product designed by physics PhDs and the related correlation bet?

Understanding a product involves understanding how it generates its return and the risks that are being taken, hence our case for curbing product design where disclosure and selling practices are unlikely to achieve effective investor protection.

No betting on the collapse of EU Member States

We contend as well that products betting on a collapse of EU Member States and foreign exchange carry trades should not be promoted as their potential damaging consequences[38] for society are well documented for no obvious additional benefit on the investor side.

We provide a detailed overview of the proposed additional rules in the Annex.

The UCITS investment rules, together with the two proposed new rules, would give a total of six categories of investment rules for PRIPS products:

1. Eligible assets and markets
2. Liquidity rules
3. Risk spreading rules
4. Rules relating to derivatives
5. Rules relating to efficient portfolio management

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37 See glossary
38 War on Want 'Costing the Casino' (2004)

6. Rules relating to payoff for structured products

Finally, as the UCITS framework needs strengthening for alternative UCITS and derivatives, we look forward to the European Commission's revision of UCITS and welcome the recent consultation and its focus on overly complex risk profiles.

We also welcome as a step in the right direction ESMA's recent guidelines on ETFs, which aim to set out the type of financial index that UCITS products can invest in.[39]

39 ESMA Consultation Paper 'Guidelines on ETFs and other UCITS issues' (2012)

If the Key Information Document is successful, then it is likely to implicitly promote packaged investment products.

II. KID analysis

The Key Information Document (KID) proposed in the PRIPS package is directly derived from the Key Investor Information Document (KIID) from UCITS and is a sound basis for the intelligible disclosure of key information on packaged products.

The fact that consumer testing conducted a few years ago on the KIID revealed some limitations as "*most customers did not read the whole document and focused selectively on particular sections, both when reading alone and guided by advisers*"[40] does not in our view question the design of the document, but only the limits of what can be achieved by information disclosure.

We welcome the inclusion of behavioural economics findings and an emphasis on intelligibility in the format of the document.

A. Too much is left at Level 2

More details should be given at Level 1 on non-market risks disclosure

The proposal follows the Lamfalussy[41] approach, as was the case for UCITS, and we appreciate that technical measures may need to be adjusted to market developments, hence their design at Level 2. Yet we feel that more detailed principles should be agreed at Level 1, in particular on the summary risk indicator as it is a cornerstone of the whole proposal.

More details could also have been provided at Level 1 on the disclosure of non-market risks and on ESG objectives, where there is a lack of universal standards.

B. Nature and objectives

The "*What is this investment?*" section is an ambitious one with six types of information included and even though we support its general design we would suggest the following changes:

State the product's market view

1. *Objectives and means for achieving them*: in addition to the description of the assets the product is invested in, its objective and possible benchmark or target, we would like to see as well a sentence describing in simple terms the implicit underlying market view of the investor purchasing this product. Such a sentence would ensure that the investor fully understands what view he is taking.

   Typically such a sentence could be as follows: "*an investor purchasing this investment product believes that EU telecom companies stocks will rise over the next 5 years and NEVER decline by more than 40% at any time during that period.*"
   Additionally we suggest preventing investment products with a fixed coupon and risk of loss on the principal from being labelled as 'fixed income' or 'income' products as such a name would be misleading: the fixed coupon is indeed only a cosmetic feature as the product still incurs a risk of loss on both return and principal.

40 IFF Research and YouGov 'UCITS Disclosure Testing' (2009)
41 See glossary

2. *ESG objectives*: There are many international ESG reference standards and conventions and as a result some ESG-labelled products or funds have a surprisingly lax interpretation of these standards, as can be seen by their investment choices. It is thus crucial in our view that the ESAs design strict and effective ESG standards building on the best frameworks, rather than the more debatable SRI standards. Failure to do so might undermine the credibility of the non-financial objectives section and risk worsening retail customers' lack of trust in the finance industry.

Effective ESG standards to avoid 'greenwashing'

In addition, we cannot agree with the formulation of the sentence "*an indication of whether the investment product manufacturer targets specific environmental, social or governance outcomes, either in respect of his conduct of business or in respect of the investment product*": it is not relevant in our view to disclose the ESG objectives of the manufacturer "in respect of his conduct of business" if they don't apply to the specific investment product.

Disclose whether product is a 'bet' or an 'investment'

We also recommend disclosing in this section whether the financial product is an investment or a bet, based on what it ultimately finances: whether companies or projects get additional funding or cheaper funding directly or indirectly as a result of the investment. This distinction is indeed fundamental in our view, as is the need to educate retail investors about it to enable them to make informed choices.

3. *Performance scenarios*: we are not quite sure about the difference between the performance scenarios mentioned in this section and the projection of possible future outcomes mentioned in the "What might I get when I retire?" section.

For clarity and consistency we would suggest removing the performance scenarios from the objectives section, and generalizing the scenario analysis in the "*What might I get when I retire section?*" to all PRIPS products. We feel indeed that rigorous performance scenarios are a useful risk assessment tool that all PRIPS products deserve, not only pension products.

C. "Could I lose money" – a misleading title

As the proposal states, all the investment products within the scope of this proposal "*seek to address a relatively simple need: capital accumulation that beats the risk-free rate*." It follows that ALL these products involve some risk of losing money, whether loss of capital invested or loss of opportunity when the return is lower than the so-called risk free rate.

The only way to beat the so-called risk free rate is to take risk

Thus we find the title misleading, as it focuses exclusively on loss of principal, and does not reflect the true nature of the products. The answer to the question is indeed yes for all products (the only way to beat the so-called risk free rate being to take risk), and asking it might give the incorrect impression that there are cases where the investor cannot lose money.

We appreciate that such a title aims at covering in simple and appealing terms the risk of principal loss, but excluding the opportunity cost changes the reference point[42] by adjusting expectations, and potentially alters the way investors evaluate products.

The title does not also reflect the fact that principal protection is provided in most cases only at maturity and is in some cases partial or conditional. Even though limitations will be disclosed, there is a risk that the main message that investors will remember is that they can or cannot lose money, without remembering the details.

In an alert published last year,[43] the SEC and Financial Industry Regulatory Authority issued warnings precisely to educate retail investors about the risks of structured notes with principal protection.

42 Thaler 'Mental accounting matters' (1999)

43 FINRA, Investor Alert 'Structured Notes with Principal Protection: Note the Terms of Your Investment FINRA', June 2011

We are also aware that such a section might have the detrimental psychological effect of implicitly promoting products that offer principal protection.

Products with 'principle protection' may do little to benefit the real economy

Since these products are often built using a zero coupon bond[44] issued by a financial institution and derivatives to gain exposure to asset classes, they usually invest only a small part of their principal in anything other than bank debt. Thus it could be argued that principal protected structured products are not very socially useful when compared to investments in stocks or bonds without principal protection.

We find it important and healthy to remember that investing involves the risk of losing money and that this is acceptable as long as the investor is aware of it. It should also be remembered that an investment where the investor cannot lose money is not an investment.

An additional concern is that capital protection, transforms the risk of loss from a high occurrence/low impact risk to a low occurrence/high impact risk, or in statistical terms from a log-normally distributed risk to a more toxic tail risk, an element that retail investors clearly fail to realize.

Capital protection can create tail risk for retail investors

Finally we hope that the limitations of principal protections to be disclosed will include highlighting that protection providers can go bankrupt and fail to deliver, and therefore that no principal protection is absolute.

D. Summary risk indicator – a double edged sword

As risk and perception of risk can be vastly different, the design of this particular section is of utmost importance.

Article 8.2.e does not provide much information on the disclosure of risks and we will thus comment based on UCITS's KIID and ESMA's related Level 2 technical advice and guidelines.

Non-market risks include liquidity, securities lending, operational and counterparty risks

First we feel that non-market risk disclosure needs to be improved, both in terms of content and format. Non-market risks such as liquidity, securities lending, operational and counterparty risks can be as or more important than market risks for some categories of PRIPS products.

Additionally, as non-market risks typically have a lower frequency of occurrence but a higher impact than market risks, their "tail" nature makes them potentially more dangerous than market risks.

Failure to communicate appropriately about them might give a deceptive appeal to products based on derivative instruments that "*exhibit a smoother pattern of returns but also carry hidden risks*" and "*increase the interconnectedness and complexity of the overall financial system".*[45] Thus non-market risks should be disclosed in a format that is comparable to the disclosure of market risks to ensure that equivalent importance is attributed to both.

Article 8.2.e also does not provide much information on the proposed summary indicator of risk and reward, as this is left at Level 2. It is thus hard to comment on this indicator since we do not know its design and methodology, and we will rather comment on what it should be and what it should not be, using as a reference point the synthetic risk and reward indicator of UCITS.

People like the simplicity of a synthetic risk indicator...

The IFF and Yougov consumer study conducted on UCITS' Synthetic Risk and Reward Indicator (SRRI) concluded that consumers "*expressed a strong preference for the synthetic indicator over the purely narrative approach. Respondents in the qualitative interviews liked the visual nature of the indicator and said that it made the risk profile easier to understand, especially for non-experienced investors.*"

44 See glossary
45 CEPS 'Will the PRIPs' KID live up to its promise to protect investors?' (2012)

Such results are not surprising as the appeal of such a seemingly simple tool is obvious. They do not imply in any way, however, that synthetic indicators are an appropriate tool.

...but that does not mean it is appropriate for them

For such an indicator to be meaningful it would need to comprehensively capture the risks involved in the underlying investment, which is probably what the investors on whom it was tested assumed, but we have some reservations about this point.

Additionally, at a time where there is a wide recognition of the need to reduce the overreliance on external ratings whose flaws have been exposed by the crisis, we would find it very surprising if the regulation proposed to introduce a synthetic risk-reward indicator in a grade format in the Key Information Document and would wonder about the consistency of such a proposal. Healthy investing involves taking the time and effort to understand the investment rather than relying entirely on other people's opinion.

As a starting point, we hope that the methodology of the summary indicator will not be a copy / paste of UCITS' synthetic risk indicator. As much as such an indicator can have some relevance for UCITS funds where most products are exposed to a simple risk of decline of the underlying assets, we doubt whether it is possible to develop a single meaningful risk indicator for all PRIPS products, given the much wider and heterogeneous range of products covered.[46]

Transposing the SRRI methodology for the summary risk indicator for PRIPs would pose three issues in our view.

Using a synthetic risk indicator for packaged investment products raises several problems

As a reminder the UCITS indicator is calculated as the volatility of the past weekly returns of the product over the past five years. The volatility fits into one of seven volatility buckets, each corresponding to a numerical grade from 1 to 7, meant to reflect the degree of risk and potential reward of each product. The size and ranges of the buckets have been calibrated so that the grades remain stable over time.

Low volatility does not mean low risk

1. First the crisis has shown the limitations of quantitative measures of risk such as volatility, and volatility derived from past performance has a weak predictive power of future risk. Incidentally, this raises the question of what is risk. We will not develop this topic here but we fully agree with the recent Kay Review that "*risk in the equity investment chain is the failure of companies to meet the reasonable expectations of their stakeholders or the failure of investments to meet the reasonable expectations of savers. Risk is not short-term volatility of return, or tracking error relative to an index benchmark*".[47] As the apprehension of risk has a huge impact on the design of financial regulations, it might be worth questioning some underlying theories that might be used by regulators and policy makers.
2. Secondly, past volatility of returns can fail to capture tail risks if they haven't occurred during the sample period. Failure to capture out-of-sample risks can lead to misleading risk assessments through the attribution of undeservedly good grades to products displaying low occurrence / high impact risks compared to products displaying the opposite features.

   As described by author Jack Schwager in his book "Hedge Fund Market Wizards"[48]: "*Low volatility does not imply low risk and high volatility does not imply high risk. Investments subject to sporadic large risks may exhibit low volatility if a risk event is not present in the existing track record. For example, the strategy of selling out-of-the-money options can exhibit low volatility if there are no large, abrupt price moves,*

46 We note that professional UCITS investors chose to rely on the Sharpe ratio, which is simple to calculate but offers the additional benefit of comparing the fund's return to its volatility, as opposed to purely looking at its volatility, and is therefore a superior indicator.

47 Kay Review final report (July 2012)

48 Jack Schwager 'Hedge fund market wizards' (2012)

but is at risk of asymptotically increasing losses in the event of a sudden, steep sell-off. (..) So some strategies, such as option selling, can have both low volatility and large, open-ended risk." JAC's 2011 response to the consultation on PRIPS initiative provides a good example of potential incorrect risk grading of financial products.[49]

The indicator must include out-of-sample risks and non-market risks

3. Thirdly, this indicator might also fail to account for non-market risks such as the counterparty risk, which can be as important as market risks for some products within the scope and are of a more dangerous nature. As an example in the case of structured notes the counterparty risk has a significant impact both on potential losses and returns: a product linked to a stock index issued by a bank with a low risk of bankruptcy might offer a participation of 70% to a rise of the index, whereas the same product issued by a bank with a higher risk of bankruptcy might offer a participation of 110%. The difference between both participation rates reflects the higher risk of default and needs to be understood by investors. We therefore hope that counterparty risks derived from credit spreads will be included in the indicator.

Assessing risk and reward in a grade format also has problems:

We have strong reservations as well on the provision of a risk and reward indicator in a grade format. Such a tool, no matter how it is designed creates three major issues in our view:

Cliff effects

1. First the well-known cliff effect that comes from a grading range: as is the case with companies and securities ratings, it is likely that investors would develop over time habits or procedures according to which products carrying a grade above a certain level are considered not suitable and products carrying a grade below are considered suitable investments.

   This could create cliff effects, as is currently the case between investment grade and non-investment grade credit ratings, which in turn could create an illusion of safety, unwarranted market psychological shocks in the case of grade change, and further deter investors from properly assessing risk.

Investors might focus too much on the grade

2. Secondly, investors are likely to focus excessively on the risk grade and pay much less attention to additional risks and limitations disclosed in the accompanying narrative. ISDA and ICMA expressed this concern as well in their response to the CESR consultation: "*The use of a single figure score would anyway detract from the wider risk disclosure in this section as retail investors are likely to place undue emphasis on the indicator (a similar weakness to credit ratings). This is of greater concern where the indicator is of questionable validity (...) A single figure rating discourages investors from fully engaging with the detail of this risk profile.*"[50]

   If such an indicator does not capture risks comprehensively, the tendency of investors to focus on it to the detriment of the accompanying narrative leads us to conclude that the drawbacks outweigh the benefits.

3. Finally, we are concerned that the inclusion of a risk grade might implicitly promote the development of packaged products as it gives an illusion of simplicity and comparability and therefore enables access to a new range of potential customers. Retail investors that were previously reluctant to invest in packaged products, as they felt they did not understand them or were unwilling to read lengthy prospectuses, might get the impression that they understand these products better and start purchasing them. However a synthetic indicator, would not provide for better understanding but

49 The Joint Associations Committee (JAC) on Structured Products comprises five trade associations: European Securitisation Forum, the International Capital Market Association, the London Investment Banking Association, the International Swaps and Derivatives Associations and the Securities Industry and Financial Markets Association. See JAC response to current consultations on the Packaged Retail Investment Products Initiative (1 February 2011)

50 JAC response to CESR Consultation on KIID template (10 September 2010)

rather an illusion of simplicity and the reliance on a methodology for assessing risk that most investors would not understand.

While it is common sense that people should not invest in products that they don't understand, it could be argued that if investors need a synthetic risk indicator and are unwilling to read or unable to understand the narrative description of the risks involved in a product, then may be the product is not suitable for them. As a recent FINRA warning put it "*If you can't understand how the product works, ask your investment professional for help. If you still can't understand the product, you should think twice about investing in it.*"[51]

Grades might implicitly promote packaged products by making them appear simpler than they are

We appreciate that a synthetic risk indicator can provide an objective assessment of risk that might in some cases counterbalance biased or incomplete advice, however the format should not be as opaque and simplistic as a grade.

Concluding from these elements, we feel that the drawbacks outweigh the benefits and we would rather not have any summary risk and reward indicator at all in the Key Information Document.

We propose that the summary risk indicator be replaced by a multifactor scenario analysis

Instead we propose that the summary risk indicator be replaced by a multifactor scenario analysis, which we will describe in a later section (see page 26).

Such a tool would display information in a more transparent way and make information easy to understand without oversimplifying it: investors would be able to see their so-called worst case scenario loss as well as so-called best case scenario return, instead of seeing a single grade with no indication on the correspondence between grades and potential losses.

Lastly as there will be a five year transition period for UCITS' KIID, we are aware that not introducing a summary indicator in PRIPS while UCITS products will display a synthetic risk indicator might introduce a bias: as investors are likely to be attracted towards the synthetic indicator, this might lead to investors favouring UCITS products in the PRIPS universe. However this issue is not significant enough in our view to change our conclusion and rather pleads for a shorter transition period for UCITS and a firm commitment to switch from UCITS' KIID to PRIPS' KID at the end.

E. Using theoretical margin at maturity to disclose costs

Fees are only a part of the costs of structured products, as some margin is embedded in investment products during the structuring phase.

Costs include embedded spreads, which retail investors cannot see

This margin is reflected in the fact that investors could have theoretically assembled the same product themselves for a cheaper cost or with a higher potential return. Since this margin is not paid upfront by investors, however, it is very difficult to quantify it as it is hidden in the cosmetics of the product.

The embedded margin can nevertheless reduce significantly the potential for positive return of the investment and we believe that it should be disclosed along with the fees in order for investors to have a comprehensive view of the costs and to create competitive pressure on the true margins.

One way to disclose embedded margins for structured products could be to require product manufacturers to disclose the theoretical margin at maturity of the structured products they build. This margin is already calculated by product manufacturers as it is added to the fair value of the product to determine its price.[52]

51 FINRA (2011)
52 Fair value: expected value of future cash flows discounted at the so-called risk free rate

F. The dilemma of past performance disclosure

The proposal indicates that past performance should be disclosed where *"relevant having regard to the nature of the product and the length of its track record"* and we support this as we are convinced that only real past performance and not backtested performance should be disclosed, and then only if the data sample is meaningful.

However the fact that past performance will not be available for some PRIPS products combined with the psychological impact of this information might create a bias in favour of products disclosing a past performance, if only some PRIPS products disclose it: despite possible warnings, a proportion of retail investors tend to believe that past performance is an indicator of future performance, and products displaying a past performance might be considered safer and be implicitly promoted to some extent.

Products displaying a past performance might be considered safer

The IFF consumer survey revealed a similar concern when testing the KIID: "*One of the key concerns in showing past performance data in a KII document is that investors will use it to gauge likely future performance in a simplistic manner. Respondents were asked to look at the two funds and to state, based on past performance, which of the two would be more likely to perform positively over the next 3 years. In the case of both variants, just under half correctly identified that it was not possible to tell this on the basis of past performance (...). Hence it would appear that past performance information will be used by some to judge likely future performance.*"[53]

This is all the more concerning as past performance can actually be sometimes an inverse indicator of future performance, as when an asset manager decides not to follow the crowd in irrational market conditions: "*Sometimes, more skilled managers will underperform because they refuse to participate in market bubbles. The best performers during such periods are often the most imprudent rather than the most skilled managers. (...) The portfolio manager of the Nevsky Fund, underperformed in 1999 because he thought it was ridiculous to buy tech stocks at their inflated price levels. This same investment decision, however, was instrumental to his large outperformance in subsequent years when these stocks witnessed a prolonged, massive decline".*[54]

Real past performance is nevertheless an element carrying informational value and as such investors deserve to have access to it. Thus bearing in mind the limitations and likely partial misuse of this information, we still agree with the Commission that it should be provided where it is relevant but think that it should not be featured too prominently in the KID to reduce the chances that investors will read too much into it. We therefore propose to display past performance at the very end of the KID.

G. Projection of future outcomes – why only pensioners?

As discussed earlier, we are not quite sure what the proposal means by "*projection of possible future outcomes*", and how it might overlap with the "*performance scenarios*" of Article 8.2.b.vi.

Scenario analyses for all products

We also wonder why only pension products should benefit from this additional information. In our view, other long term investment products and in fact all investment products deserve to display such information.

We believe indeed that scenario analyses, if rigorously conducted, would be a superior risk assessment tool than a synthetic risk and reward indicator. It would not be perfect as it is based on the Value-at-Risk methodology whose weaknesses are known, but would still carry informational value and disclose it in a more transparent format.

We are thus in favour of displaying scenario analyses for all products in this section, and logically to rename it *"Indicative future performance scenarios".*

53 IFF Research and YouGov (2009)
54 Jack Schwager 'Hedge fund market wizards' (2012)

The Level 3 guidelines on performance scenarios for structured funds in UCITS could be used as a basis for the design.[55]

As consumer testing on performance scenarios for structured funds in UCITS evidenced higher understanding with a table format over a chart format, a simple table with three columns should be used.[56] We recommend additional consumer testing to determine the optimal format of disclosure for this scenario analysis table. As an example, percentages might have to be reformatted into hard figures for simplicity purposes. It might be also interesting to draw inspiration from the probability tables of Italian regulator of the securities market Consob.[57]

We propose the following indicative framework:

Simulate three scenarios of returns for the product, a worst case scenario inside a 99% confidence interval, a median case and a best case inside a 99% confidence interval over the life of the product. When the product has no maturity, an indicative period would need to be chosen by the European Supervisory Authorities in charge of designing the technical standard based on the average holding period for this class of instruments.

Scenario analyses are less opaque and not overly simple

The parameters simulated should be each of the significant risk exposures of the product, 'significant' in this case meaning that their potential impact on the return is higher than 1% of the notional. The risks simulated should also include counterparty risks derived from credit spreads. The inclusion of multiple risk factors could be done using stressed correlations. The scenario analysis could be displayed in a table showing the potential future cumulative returns under each scenario expressed as a percentage of the notional at different points in time, the number of periods being between five and 10, depending on the maturity of the product.

The table format discloses information in a more transparent way than a grade while remaining intelligible: investors are able to see the so-called worst case scenario loss on their investment as well as more favourable potential returns. This is superior in our view to a single grade with no indication on the correspondence between grades and potential losses.

On the argument that some retail investors who struggle with numbers might find the table harder to read than a grade, we would argue that it might be a healthy warning, in that investors who struggle with numbers might want to think twice before investing in packaged products. Figure 5 on the next page provides an illustrative example.

This proposal is consistent with Finance Watch's recommendation on external credit ratings, that agencies should disclose probabilities of default instead of letter-based ratings.[58] In both cases the information is similar but the psychological impact is radically different, as the incentive to focus overly on the grade is greatly reduced.

55 CESR level 3 guidelines on the selection and presentation of performance scenarios in the Key Investor Information document for structured UCITS' (2010)
56 IFF Research and YouGov (2009)
57 Consob 'A quantitative risk-based approach to the transparency on non-equity investment products' (2009)
58 Finance Watch, 'A proposal for reforming credit ratings agencies' (24 January 2012)

Figure 5: Indicative future performance scenarios

	Negative scenario	Median scenario	Positive scenario
Now	0%	0%	0%
in 6 months	-6%	2%	2%
in 1 year	-3%	4%	7%
in 18 months	-8%	3%	4%
in 2 years	-7%	3%	9%
in 2.5 years	**-13%**	3%	6%
in 3 years	-12%	5%	11%

Source: Finance Watch

We argue that it would be consistent to adapt not only the KIID but also investment rules from UCITS

Conclusions

The proposal on key information documents for investment products is promising and we fully support its objectives of increasing transparency and of levelling the playing field for disclosure between different legal formats.

Direct product regulation is needed to make sure products are suitable

We regret, however, that only the KIID of UCITS is seeing its scope expanded to the PRIPS universe and would have liked to see also UCITS investment rules adapted to the new scope.

We find it important to keep in mind that there is only so much that disclosure alone will achieve. Even when taking into consideration MiFID and IMD's future measures addressing conflicts of interests in sales practices, it is unlikely to significantly help retail investors to make suitable investment decisions, due to imperfect advice, lack of financial literacy and psychological biases. Therefore other dimensions such as suitability should be introduced through direct product regulation.

We must not create an illusion of simplicity

As no format or any indicator will ever be perfect we appreciate that improving disclosure formats is a difficult exercise and we must be careful not to create a misleading illusion of simplicity and comparability of the PRIPS products that would not reflect the reality.

We should think about where we want to direct savings

Lastly, we want to stress once again the political dimension of where we want to direct savings and warn about the possible unintended consequence of implicitly promoting packaged investments products that might not be socially desirable.

This proposal is thus a great opportunity that should not be missed to direct savings towards socially useful investments.

Based on these conclusions, we would recommend the following changes to the proposal:

Recommendations:

1. Widen the scope and further specify some terms in Article 2's exclusion list.
2. Add suitability and social usefulness dimensions through the introduction of investment rules.
3. Disclose in ESG objectives whether the financial product is a bet or an investment.
4. Remove the summary risk indicator.
5. Replace it with a multifactor scenario analysis for all PRIPS products.
6. Disclose in the cost section the theoretical margin at maturity of structured investment products.

ANNEX: INVESTMENT RULES FRAMEWORK PROPOSAL

Finance Watch proposes to adapt UCITS Articles 49 to 57, which we will do in our forthcoming amendments proposal, and in addition to amend Article 50 and add two additional rules, as below.

1. Restrictions on eligible assets for products sold to retail consumers

We propose to amend Article 50 of the UCITS Directive:

1. The eligible investments of products sold to retail customers shall comprise only one or more of the following:
   - (a) Transferable securities using UCITS definition *except financial instruments backed by or linked to the performance of other assets which may differ from those referred to in Article 19(1) of UCITS*, and money market instruments dealt in on a regulated market;
   - (b) Units of authorized UCITS funds or other collective investment undertakings;
   - (c) Deposits with credit institutions maturing in no more than 12 months;
   - (d) Financial derivative instruments including equivalent cash settled instruments dealt on a regulated market or over the counter, provided that the underlying consists of instruments covered in this article, interest rates, foreign exchange rates, currencies, financial indices *whose underlying components are eligible assets and subject to point (3)*;
   - (e) Other money market instruments (using current definition)
   - *(f) Recently issued transferable securities with an intention to list within 1 year of issue.*
   - *(g) No direct or indirect exposure to commodities, non-UCITS funds, non-financial indices is allowed.*

2. Physical and *synthetic* uncovered sales of transferable securities, money market instruments and other eligible assets shall not be carried.
3. Proprietary and strategy indices must respect ESMA's guidelines for strategy indices[59] on diversification, rebalancing frequency, disclosure; their embedded leverage must be lower than or equal to 2, and must be included in the calculation of global leverage.

Explanation:

We propose to generally follow UCITS list of eligible assets and markets while ensuring that indirect exposure cannot be gained to non-eligible assets. We therefore propose three main changes:

1. Remove from the definition of transferable securities financial instruments included in Article 2(2)(c) of Directive 2007/16/EC as this article qualifies as transferable securities

59 See box 8, page 28 of ESMA Consultation Paper 'ESMA's guidelines on ETFs and other UCITS issues' (2012)

financial instruments linked to the performance of assets other than eligible ones, as noted by the European Commission's recent consultation on UCITS;[60]

2. Tighten the definition of indices to ensure again that they do not allow exposure to non-eligible assets through their underlying components.

   ESMA's proposed guidelines on ETFs setting up the type of financial index that UCITS can invest in[61] are a step in the right direction, however we would go further and remove commodity indices from the list of eligible indices.

3. Remove the possibility to invest up to 10% in transferable securities and money market instruments other than those referred to in UCITS Article 50 paragraph 1, as we feel that the rule on eligible assets should be enforced without exception.

2. Additional sub-rule relating to derivatives:

We propose to add the following rule:

The following types of derivatives are eligible to be used when designing products:

(i) Plain vanilla swaps and forwards/futures;
(ii) Plain vanilla options and simple barrier options, subject to point (iii);
(iii) Binary options, provided that the ratio of the notional amount of binary options sold[62] divided by the investment product notional amount is lower than or equal to 10% for each individual option, and 20% for the total of all binary options sold;
(iv) Average rate options.

Explanation:

The underlying of the derivative instruments proposed above should be those described in eligible assets 1(d).

As discussed, setting eligibility criteria on the type of derivative that can be used is in our view necessary, together with rules on payoffs to ensure that the risk profiles of the investment products are both understandable by retail investors and not excessively exotic.

Swaps forwards and futures are allowed, e.g. vanilla interest rate swaps, cross currency swaps, FX forwards, currency swaps, equity futures, vanilla equity swaps. Simple basic options, simple barriers options and average rate options are also allowed. This range of instruments and their possible combinations offer a very wide range of structures enabling investors to express most simple market views.

More complex derivatives such as structured barriers, path-dependent derivative instruments[63] should however not be allowed as they create more complex risk exposures that are not understandable by non-professional investors.

We also suggest capping the digital risk as it creates jumps in structures payoffs: a digital risk is typically found in binary or barrier options where a small price modification in the value of the underlying asset can trigger a significant fixed payoff, leading to a sudden jump in the investor's return. Therefore in order to limit potential violent declines in payoffs, we propose capping the notional of binary options sold relative to the notional of the investment product.

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60 European Commission consultation 'Undertakings for Collective Investment in Transferable Securities' (2012)
61 ESMA guidelines on ETFs and other UCITS issues (2012)
62 By sold binary options we mean binary options, including the binary part of barrier options and tight plain vanilla options spreads replicating binary payoffs, where the investors sees his return decline by the corresponding payoff if the strike is hit. Thus selling a one touch FX option, buying a no touch FX option, selling a very tight put spread would be captured by that definition, as would the embedded part of selling a put with a knock-in barrier in the money or buying a put with a knock-out barrier in the money.
63 Except simple barrier options and Asian options

3. Rules relating to payoff structures for structured products:

We propose to add the following rule:

The payoff of a structured product shall only be:

(a) A directional exposure to one or several eligible assets;
(b) In the case of several assets, they can be combined as simple spreads, simple baskets, best-of and worst-of baskets;

Investment products payoffs shall not, however:

(c) Be a direct or indirect, cash or synthetic short exposure to EU sovereign credit risk;
(d) Be FX carry trades, whether cash or synthetic (e.g. selling out of the money currency options in a currency pair with a high interest rate differential)
(e) Include a conditional extension of maturity. Potential shortening of maturity shall however be authorised, as in the case of callable products;
(f) Be path-dependent, except for the use of simple barrier and Asian options under the conditions detailed in derivatives rules;
(g) Be a net seller of volatility;
(h) Offer a fixed boosted return during the first years followed by a conditional payoff, boosted meaning exceeding market conditions at the time of trade;
(i) Offer principal protection if this protection is:
    (i) On less than 80% of the notional
    (ii) Conditional
    (iii) Capped

Explanation:

The main purpose is to ensure that structured products with excessively non-linear payoffs and overly complex risk factors are not proposed to retail investors, as they pose greater suitability issues.

As much as we are dubious about retail investors' ability to have an educated opinion on future interest curve shapes and hybrid exposures, provided the loss profile of the product is not too abrupt we do not propose to exclude these products from the scope.

We propose however to remove from the scope financial products betting on a collapse of EU Member States and foreign exchange carry trades, as the potential damaging consequences[64] for society are well documented for no obvious additional benefit on the investor side.

By directional exposure we mean that the main market risk of a structured product must be the risk of rise or decline of the underlying assets. Other risk factors such as volatility must remain secondary.

Proposed rule (e) aims at ensuring that products including a possible extension of maturity are not allowed; it is our conviction indeed that investment products, where a barrier trigger leads to a lengthening of the product maturity are very difficult to understand as they generate value by creating uncertainty on the product maturity date. Retail investors are used to have uncertainty on the return of the investment, including principal redemption, but much less to uncertainty being located on the product maturity.

Product features such as callability, which enable the seller to redeem the product earlier than its maturity date also play on the maturity factor, however they are potentially less detrimental to retail investors in our view as they do not create potential liquidity issues for them.

64 War on Want 'Costing the Casino' (2004)

We propose to ban path-dependency, except related to barrier/binary and average rate options, as this feature can create complex risks that are difficult to understand. Structures such as target redemption products and snowballs[65] are indeed not suitable in our view for retail investors and require more than a basic understanding of derivatives to be properly assessed.

Similarly, as much as the principle behind mountain range options[66] can be easily understood, the underlying market view on correlation and market scenarios are not.

Selling options implies an unlimited loss potential for a limited return, and while selling options can offer some benefits when combined with other instruments, generally speaking a payoff profile that is a net seller of volatility is not desirable in the case of retail investors, as the appeal of the premium earned might outweigh the understanding of the risks incurred and as selling options is traditionally the role of professional market makers. Therefore while selling options should be permitted when combined with purchasing other options, we recommend prohibiting payoff structures that are net sellers of volatility.

Structures offering a teaser boosted fixed return during the first years followed by returns tied to exotic indices can appeal to non-professional investors because of the hyperbolic discounting bias.[67] However as there is a demonstrated history of mis-selling linked to this type of structure[68] and as this is only a cosmetic feature, we think that it should not be allowed for retail investment products.

Finally, consumer testing studies have shown that when principal protection is mentioned, investors tend to focus on it and forget its limitations. However several investment products offer severely limited principal protection, such as products where the investor is protected against a decline of 30% of the underlying but has no protection against further losses. We find that calling such a feature “principal protection” can be misleading and thus propose to ensure that only principal protection features that offer a significant level of protection should be labelled as such.

65 See glossary
66 Complex basket structures with significant correlation risk, such as Himalaya products. See glossary
67 The tendency for people to have a stronger preference for more immediate rewards relative to later rewards
68 The Guardian, 6 September 2011, ‘French local authorities with Swiss franc loans risk toxic timebomb’

Glossary

Absolute return: Absolute return investment products follow a strategy seeking to make positive returns both in rising and falling markets through techniques such as short selling and use of derivatives.

Anchoring: tendency to base decisions on pieces of information that have no relevance to the actual problem.

Average rate option: an option whose return is linked to the average price of the underlying asset over the life of the option. By contrast, basic or "plain vanilla" options have their return linked to the value at maturity of the underlying asset.

Barrier option: a type of derivative instrument whose payoff is linked to the underlying asset reaching or not a specific predetermined level.

Behavioural economics: a branch of economics that integrates findings of psychology through the study of the impact of cognitive and emotional elements on the economic decision making of individuals.

Best of basket / worst of basket: a group of assets (shares, currencies etc) whose return is that of the highest / lowest performing asset in the basket.

Binary option: a type of derivative instrument whose return is either a fixed amount or nothing depending on whether the underlying asset has reached a predetermined specific level or not. The "all or nothing" nature of this instrument can create big jumps in investment products returns for very small price modifications of the underlying asset.

Carry trade (currency): a strategy where an investor borrows money at a low interest rate in one currency in order to lend at a higher interest rate in another currency. The investor is exposed to the risk of fluctuation in the currency exchange rate between the two currencies. It has been documented that currency carry trades can lead to very quick influx and exit of large sums of money in the related countries with destabilising effects on their economy, inflation and employment.

Confidence interval: a statistical term describing the probability that a value will fall between an upper and a lower bound. As an example, "a worst case loss of €1000 inside a 99% confidence interval" means that in 99% of cases the investor should not lose more than €1000 and in 1% of cases he could lose more than €1000.

Convexity risk: risk of larger and larger losses for each percentage point change in the underlying asset.

Correlation risk: risk that the actual correlation between two assets will be different from what had been estimated, leading to losses.

Counterparty risk: the risk that the other party in a contract will default and fail to deliver on its obligations.

Curve trade: an investment strategy betting on the evolution of short-term interest rates versus long-term interest rates.

Delta: ratio measuring the price change of a derivative instrument versus the price change of the underlying asset.

Digital risk: risk of "jump" or discontinuity in the return of a derivative instrument such as a binary option (see binary option).

Directional exposure: exposure to the rise or decline of an asset.

Forward: contract between two parties to buy or sell an asset at a future date for a price fixed today.

Framing: the fact that people react differently to a particular choice depending on how it is presented, for example whether it is presented in terms of possible profits or possible losses.

Futures contract: similar to a forward contract but with standardized terms and dealt on a regulated exchange.

Heuristic: heuristics are mental shortcuts or "rules of thumb" used to shorten decision making and problem solving. Heuristics are helpful in many situations but can also lead to biases. The "affect heuristic", where people make decisions based on their feelings, is one such bias.

Key Investor Information Document: synthetic information document on investment funds introduced by the European UCITS directive. This document is meant to be short and easy to understand rather than exhaustive. The provision of this document to investors before their purchase is mandatory. The Key Information Document of the current PRIPS proposal is adapted from it.

Lamfalussy approach: a process used in European financial regulation that distinguishes four levels of regulation. At the first level, legislation adopted by the European Parliament and the Council of the European Union establishes core principles, whereas technical specifications are left at the second level to regulators.

The third level sees national regulators coordinating new regulations with other countries. The fourth level focuses on the compliance and enforcement of the law.

Loss aversion: when people prioritize avoiding losses over making gains. Loss aversion is a known bias in investment decision making.

Mountain range option: a type of derivative instrument based on a basket of several assets. The price of this instrument depends mostly on the correlations between the assets in the basket. Such instruments often have mountain names such as Himalaya, Annapurna or Everest and are therefore referred to as mountain range options.

Operational risk: The Basel Committee on Banking Supervision defines operational risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events". It includes amongst others the risk of fraud or the risk that a trader will exceed its risk limits, leading to unexpected large losses.

Path-dependency: path-dependent derivatives are financial instruments whose value is linked not only to the value at maturity of the underlying asset but also to its values at several points during its life. As an example, investments whose return becomes zero if the underlying asset reaches a specific level at any time are path-dependent. Such instruments imply more specific market anticipations and require a greater financial knowledge.

Payoff: in the context of financial instruments, the payoff of an investment is its risk and reward profile. The payoff profile of an investment describes its potential for gains and losses depending on the value of the underlying assets and other risk parameters.

Snowball product: a snowball structured product is a type of investment whose annual return is dependent on the underlying asset and also on the previous year's return. This type of instrument can therefore compound gains or losses at a very quick rate and is highly risky.

SRI standards: SRI stands for Socially Responsible Investing. This generic term describes investment strategies taking into consideration so called ESG (environmental, social and corporate governance) criteria. SRI funds can work on the basis of a selection of companies respecting best ESG criteria (so-called "best in class" funds) or can operate by excluding certain companies because of their activity (tobacco, gambling...) or because of their environmental, social or corporate governance behaviour.

Swap: a financial agreement between two parties where they temporarily exchange assets or financial flows such as securities, interest rates or currencies.

Tail risk: risk of financial loss linked to the occurrence of rare extreme events. Tail risks are hard to assess as they occur infrequently but usually entail large losses. Most financial models assume that financial assets follow a log-normal distribution of returns which underestimates the likelihood of extreme events and therefore of tail risks.

Target redemption product: a financial product offering a guaranteed rate of return but entailing a risk of early termination: once the cumulative returns reach a predetermined level, the product stops automatically and the investor gets his or her money back. This means that the potential gains of the product are capped by this automatic early redemption feature, whereas the potential losses are not capped.

Unit-linked insurance: type of life insurance product whose value fluctuates according to the market value of its underlying assets (shares, bonds, funds etc.).

Volatility: the volatility of a financial product measures the fluctuation of its returns: the larger and the more frequent the fluctuations, the higher the volatility. Mathematically speaking, volatility is the square root of the variance. Volatility risk is found in financial instruments such as options.

Zero coupon bond: a bond that does not pay periodic interest but in exchange trades at a discount to its redemption value.

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Timetable for next months:

30 October – Council Working Group (national experts)
6 November – ECON exchange of views
Mid-November – ECON draft report
26 November – ECON presentation of draft report
December – ECON amendment deadline
20 March – ECON vote
8 May – Plenary vote

About Finance Watch

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. Its members represent, collectively, many millions of European citizens and include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

Finance Watch is funded by grants, donations and membership fees. It does not accept any funding from the financial industry or political parties. For 2012, Finance Watch has also received funding from the European Union to implement its work programme (there is no implied endorsement by the EU of Finance Watch's work, which is the sole responsibility of Finance Watch).

Finance Watch was registered on 28 April 2011 as an Association Internationale Sans But Lucratif (non–profit international association) under Belgian law. For further information, please visit www.finance-watch.org.

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