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Building blocks of investor protection: All-embracing regulation tightens its grip

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Building blocks of investor protection:
All-embracing regulation tightens its grip

Abstract

The financial sector has faced a true regulatory avalanche since the financial crisis. The field of investor protection legislation has not escaped. This article takes a step back and structures the multitude of new rules with respect to investor protection – both at national and EU level – into three "building blocks of investor protection": (i) product information requirements; (ii) services quality requirements (conduct of business rules); and (iii) product regulation. By doing so clear trends emerge.

First, this contribution shows that although over the last decades severe criticism has impaired confidence in the traditional "information paradigm" as an investor protection solution, the paradigm is far from buried. It remains an important pillar of investor protection, although it has been fine-tuned and adapted to certain law and economics and behavioural finance insights.

Second, the information paradigm has been supplanted with newer types of investor protection. Conduct of business rules, emphasizing the role of services providers in the investment process, become ever more detailed and encompassing.

Third, a new trend – and indeed paradigm shift – emerges. Until recently product regulation was virtually inexistent; today three different types of product regulation can be distinguished: (i) product quality requirements; (ii) regulation of the product design process; and (iii) outright product bans. Each of those measures prohibit or impede access to certain financial products by (categories of) investors. Whereas less than a decade ago such measures were unheard of in the financial sector, the crisis has matured thinking in this direction. Today outright product banning has been institutionalized at EU level and can be considered the backstop of EU investor protection legislation.

The author concludes the contribution with an evaluation of the current state of play and an indication of remaining challenges in the field of investor protection legislation.

Keywords: financial regulation, investor protection, information paradigm, conduct of business rules, product intervention

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Introduction

1. Building blocks of investor protection. In recent years European Member States, as many other countries around the globe, have witnessed a tidal wave of new financial regulation in general and investor protection legislation in particular, making it difficult to see the forest for the trees.

In this contribution, we offer a way out of the forest by structuring this multitude of rules into three "building blocks of EU investor protection": (i) product information; (ii) service quality requirements (conduct of business rules); and (iii) product regulation.[1]

Drawing from legal history, comparative law,[2] as well as law and economics and behavioural finance literature, this allows to identify and evaluate the main trends in EU investor protection legislation, but also to point out remaining gaps and challenges.

I. Product Information.

A. Background

1. The information paradigm

2. Information paradigm. The oldest means of investor protection is the provision of information. The "information paradigm" is based on the assumption that information asymmetry is a market failure causing suboptimal investment decisions. Mandatory disclosure of product information would in these circumstances take away information asymmetry and enable retail investors to take rational decisions.[3] It would thus lead to better, more 'informed' investor decisions and protection against 'wrong' decisions resulting from a lack of knowledge ("empowerment of investors").[4] This in turn would lead to stronger market-based saving.[5]

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[1] Moloney makes a similar distinction, but adds two further categories: education, and supervision, enforcement and redress (N. Moloney, *How to Protect Investors. Lessons from the EC and the UK* (Cambridge University Press 2010)). Although those categories are obviously highly important for an encompassing investor protection regime, this paper focuses on the legislative aspects of investor protection, leaving investor education, supervision and redress out of scope. Company law rights for shareholders and bondholders are not considered either.

[2] The author has examined national evolutions in investor protection legislation in Belgium, Germany, France, the Netherlands and the UK.

[3] Enriques and Gillotta give an excellent critical overview of the goals of market disclosure in financial regulation. They identify three main goals: (i) investor protection; (ii) addressing agency problems; and (iii) price-accuracy enhancement. See L. Enriques and S. Gilotta, "Disclosure and Financial Market Regulation" in N. Moloney, E. Ferran and J. Paige (eds), *The Oxford Handbook of Financial Regulation* (OUP 2015) 511. See in this respect also Emilios Avgouleas, "The Global Financial Crisis and the Disclosure Paradigm" (2009) ECFR, 440-475.

[4] Among many others: H. Beales, R. Craswell and S. Salop, 'The efficient regulation of consumer information' (1981) Journal of Law and Economics 513; S. Grundmann, W. Kerber and S. Weatherill, 'Party Autonomy and the Role of Information in the Internal Market – An Overview' in *Party Autonomy and the Role of Information in the Internal Market*, (de Gruyter 2001) at 3: "*And part of this presumption is, second, that information rules have to be preferred to mandatory rules prescribing substance whenever meaningful information of the client is possible. Information rules, even if mandatory, diverge fundamentally form traditional mandatory rules that fix the content of the contract… They are designed to enable party autonomy, they do not restrict the variety of products and contractual conditions that are available*"; G. Hadfield, R. Howse, M.J. Trebilcock, 'Information-Based Principles for Rethinking Consumer Protection Policy' (1998) Journal of Consumer Policy at 152. In the context of securities regulation also: D. Llewellyn, 'The Economic Rationale for Financial Regulation' (FSA Occasional Paper OP01, April 1999) http://www.fsa.gov.uk/pubs/occpapers/OP01.pdf at 21; V. Mak, 'The Myth of the 'Empowered Consumer' - Lessons from Financial Literacy Studies' (2012) 4 Journal of European Consumer and Market Law at 254-255.

[5] E.g. Moloney, *How to Protect Investors* (n1) at 288-290, with further references.

3. Prospectus obligation as prototype. The prospectus requirement is the prototype of the information paradigm. It obliges firms to produce an elaborate information document when offering transferable securities to the public. This document must include "*all information which … is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities*".[6] Such obligation originates from the 19th century in many Member States,[7] but has been harmonized at EU-level since the 1980's.[8] The UCITS Directive introduced a specific prospectus obligation for investment funds qualifying as "undertakings for the collective investment in transferable securities", which should "*include the information necessary for investors to be able to make an informed judgement of the investment proposed to them*."[9]

2. Problems associated with the information paradigm

4. The excesses, downsides and malfunctions of the information paradigm are however well-known.

5. Information overload. First, it has been shown that there is a negative correlation between the quantity of the information which is provided and the chances that a consumer will actually read it.[10] A pile of technical information has a discouraging effect and may result in consumers not reading anything or only less important parts.[11] If processing the information is more costly than the expected benefits of the information, ignoring the information may even be the more efficient decision (referred to as "rational ignorance").[12] It has been claimed that this is not necessarily problematic, since market prices reflect all relevant information in

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[6] Wording of art. 5(1) of Prospectus Directive 2003/71/EC.

[7] Although mandatory information obligations were introduced in the 19th century in several Member States, more generalized information and prospectus obligations were advanced in the aftermath of the crisis of the 1930s. See for the UK e.g. A. Hudson, *Securities Law* (Sweet & Maxwell 2008) 143-154; for Germany: K. Hopt, 'Von Aktien- und Börsenrecht zum Kapitalmarktrecht, Teil 2: Die Deutsche Entwicklung im internationalen Vergleich' (1977) 141 ZHR 389; for the Netherlands: C. Grundman-Van de Krol, *Koersen door de Wet op het Financieel Toezicht* (Boom Juridische Uitgevers 2012) 4-5); for Belgium: T. Van Dyck, *De geharmoniseerde prospectusplicht* (die Keure 2010).

[8] First by Directive 80/390/EEC and later by Prospectus Directive 2003/73/EC.

[9] Originally art. 27 and 28 of Directive 1985/611/EEC; today art. 68 and following of the consolidated UCITS Directive 2009/65/EU.

[10] See e.g. R. Deaves, C. Dine and W. Horton, 'Research Study. How Are Investment Decisions Made?' (Commissioned by the Task Force to Modernize Securities Legislation in Canada, 24 May 2006) http://www.tfmsl.ca/docs/V2(3)%20Deaves.pdf, at 306 : "People will shut down if they are confronted with a mountain of ill-presented data" (see also at 263 and 285).

[11] It has been shown, for instance, that the growth in the market of complex structured securities in the years before the 2007 crisis was possible notwithstanding the existence of elaborate disclosure documents relating to the risks of those products. See Avgouleas (note 3) at 444, with reference to S. Schwartz, "Disclosure's failure in the subprime mortgage crisis" (2008) Utah Law Review 1109. They argue that market actors did not adequately process available disclosure documents, not only because of information overload, but also as a consequence of behavioural biases and heuristics (see further references in footnote 14).

[12] For a critical analysis see A. Schwartz, D. Grether and L. Wilde, 'The irrelevance of information overload: an analysis of search and disclosure' (1985-86) Southern California Law Review at 278 and following, with further references; Hadfield, Howse and Trebilcock (note 4) at 145; R. Prentice, 'Whither Securities Regulation? Some behavioral observations regarding proposals for its future' (2002) *Duke Law Journal* 1448-1449, footnote 241, with further references; T. Paredes, 'Blinded by the light: information overload and its consequences for securities regulation (2003) 81 *Washington University Law Quarterly* 417; G. Benston, 'Consumer Protection as Justification for Regulating Financial Services Firms and Products' (2000) Journal of Financial Services Research 290; S. Grundmann and W. Kerber, 'Information Intermediaries and Party Autonomy – The Example of Securities and Insurance Markets' in *Party Autonomy and the Role of Information in the Internal Market* (2001 Walter de Gruyter) 264-310 at 266, with reference to Stigler.

an efficient capital market ('Efficient Capital Markets Hypothesis'). Even if investors do not read the prospectus, they will therefore pay a correct price for a publicly traded financial instrument. To what extent the ECMH holds, is, however, widely disputed.[13] Moreover, even if the ECMH would hold, it cannot ensure that an investor buys a product corresponding to his or her needs, objectives and financial situation. This still requires an assessment of available product information.

6. Limits to investor rationality. Even worse, behavioural economics in general, and behavioural finance in particular, have wiped the floor with the very foundations of the information paradigm. It has been shown that even if more compact product information is readily available, investors are likely to ignore or misinterpret it. A plethora of psychological heuristics and biases steer the behaviour of the investor and explain why they do not optimally use the information provided.[14]

7. Cost. For the product provider, compliance with heavy information requirements is not without costs (such as compiling, monitoring, compliance and transmission costs).[15] Moreover, it has been argued that the larger the amount of information released to the public and the more frequently disclosures have to be made, the higher the probability of issuing an incomplete or misleading statement and the greater the liability risk for the product provider.[16] Those costs will often, at least in part, be passed on to the retail investor (via price-setting for the products or services),[17] which is all the more cynical if retail investors do not or hardly benefit from such information.

8. Information and responsibility. To top it off, information finally also generates responsibility. If it can be proven that accurate information has been disclosed, the supposedly informed consumer of financial services shall, under certain circumstances, be considered responsible for his or her own acts. The provision of product information can therefore lead to a shift of liability risk to the retail investor.[18]

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[13] See for a recent critical appraisal of the role of the ECMH in today's capital markets and financial regulation: J. Gilson and R. Kraakman, 'Market efficiency after the financial crisis: it's still a matter of information costs' (2014) 100 Virginia Law Review, 313. For an in depth discussion of the multiple goals of the prospectus, see also: Enriques and Gilotta (note 3) at 515-516 and 528.

[14] See the seminal work of C. Jolls, C.R. Sunstein and R. Thaler, 'A Behavioral Approach to Law and Economics' 52 (1998) Stanford Law Review 1471. With respect to financial services specifically, see (amongst others) Prentice (note 12); Decision Technology Ltd, 'Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective - Final Report' (November 2010) http://ec.europa.eu/consumers/strategy/docs/final_report_en.pdf, with many further references in part I at 23 and following; Financial Conduct Authority, 'Two plus two makes five? Survey evidence that investors overvalue structured deposits' (Occasional Paper No.9, March 2015), with further references; S. Schwarcz, 'Regulating Complacency: Human Limitations and Legal Efficacy" (working paper, March 2017), available at http://scholarship.law.duke.edu/faculty_scholarship/3710/).

[15] The direct costs of market disclosure are in large part fixed. Therefore, they tend to be more burdensome for smaller firms, putting them at a competitive disadvantage vis-à-vis larger ones. See F. Easterbrook and D. Fischel, 'Mandatory disclosure and the protection of investors' 70 Virginia Law Review (1984) 669, at 671 and more recently Enriques and Gilotta (note 3) at 539.

[16] See Enriques and Gilotta (note 3) at 531.

[17] Easterbrook and Fischel (note 15) at 696; Hadfield, Howse and Trebilcock (note 5) at 152: "*The true focus of consumer protection policy, as distinct from competition policy, is … the quality and cost of consumer information*."

[18] T. Van Dyck, *De geharmoniseerde prospectusplicht*, (Brugge, die Keure 2010) nrs. 78 and following.

B. Recent trends

1. Focus on presentation of information

9. Importance of "presentation". These insights have been fuelling the academic debate for quite a while. More recently, the legislature has also used them as a basis for policy change.[19] Although prospectus obligations prevail, new measures have been added, which increasingly put the emphasis on the need for short, comprehensible and comparable product information.

10. UCITS – from simplified prospectus to KIID. In 2001 the third update of the UCITS Directive ("UCITS III")[20] introduced a "simplified prospectus" to be available next to the full prospectus. "*Such a new prospectus should be designed to be investor-friendly and ... should give key information about the UCITS in a clear, concise and easily understandable way*".[21] Although the idea behind the simplified prospectus was laudable, it did not achieve its goal: it was still considered "*too long and complex and, thus of limited value to the investors*", whereas it entailed "*considerable cost overhead for the fund industry*".[22] When the European Commission set up a fourth review of the UCITS Directive, efficient disclosure was therefore one of the key components.[23] After elaborate consumer testing,[24] the UCITS IV Directive 2009/65/EC replaced the simplified prospectus with a "Key Investor Information Document" or "KIID" providing Key Investor Information on the fund in a short document of maximum 2 A4 pages.[25] The KIID has a standardized format which should allow easy comparison. A so-

[19] Two studies commissioned by the European Commission have been of major importance in this regard: (i) a study in preparation of the UCITS IV Directive (Decision Technology Ltd, 'Consumer Decision-Making in Retail Investment Services' (note 14); and (ii) a study in preparation of the PRIIPs implementing legislation (London Economics and Ipsos, 'Consumer testing study of the possible new format and content for retail disclosures of packaged retail and insurance-based investment products – Final Report' (MARKT/2014/060/G for the implementation of the Framework Contract n° EAHC-2011-CP-01, November 2015)). The Joint Committee of the European Supervisory Authorities explicitly justifies the latter consumer testing study as follows: "*Research into consumer behaviour in investment decision making has also shown the detrimental effects of behavioural biases. For instance, retail investors often tend to focus more on the 'reward' or 'performance scenarios' of an investment product than the effect of costs, or to overvalue immediate rewards or risks, over long term rewards or risks. Given this, a traditional approach to disclosures focused solely on information and with little regard to its presentation, is being superseded in policy making by an approach that is more informed by insights into consumer behaviours." … "consumer testing … will be used to select options on the basis of how consumers react in terms of comprehension, comparability and 'engagement'.*" (JC/DP/2014/02, "Discussion Paper - Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs)" (17 November 2014) at 17).

[20] Directive 2001/107/EEC [2002]OJ L41/20.

[21] Recital 15 of Directive 2001/107/EEC. The content of the simplified prospectus was elaborated by Commission Recommendation 2004/384/EC [2004] OJ L199/30.

[22] European Commission, Impact assessment of the legislative proposal amending the UCITS Directive (SEC(2008) 2263) 12.

[23] European Commission, 'Initial orientations of possible adjustments to UCITS Directive (85/611/EEC) – Overview of key features', http://ec.europa.eu/finance/investment/docs/ucits-directive/overviewexposure_en.pdf; European Commission, 'Exposure Draft, Initial orientations for discussion on possible adjustments to the UCITS Directive - 5. Simplified prospectus – Investor Disclosure Regime', http://ec.europa.eu/finance/investment/docs/ucits-directive/prospectusexposure_en.pdf.

[24] IFF Research and YouGov, 'UCITS Disclosure Testing - Research Report' (June 2009) http://ec.europa.eu/finance/investment/docs/other_docs/research_report_en.pdf.

[25] Art. 78 and recital 59 of Directive 2009/65/EU, implemented in detail in art. 7-24 Regulation (EU) N° 583/2010.

called “synthetic risk and reward indicator” (SRRI) expresses the riskiness of the fund on a numeric scale from 1 to 7, supplemented by a narrative explanation.[26]

11. Summary prospectus. In line with the UCITS simplified prospectus, Prospectus Directive 2003/71/EC requires the inclusion of a “summary” in the prospectus to convey “*in a brief manner and in non-technical language*” “*the essential characteristics and risks associated with the issuer, any guarantor and the securities*”.[27] Recital 21 of the Directive set a maximum of 2500 words for the summary. Such recital not being binding, this word limit was, however, more often than not neglected. The summary prospectus therefore suffered from the same problem as the full prospectus: it was still too long and too technical for (retail) investors to read.[28] Directive 2010/73/EU amended the Prospectus Directive on this point (among other things). The “summary prospectus” should now only provide “key information” and be “*drawn up in a common format in order to facilitate comparability*.”[29] The Implementing Prospectus Regulation (EU) nr. 809/2004 not only sets out detailed content requirements and a mandatory order for the summary, it also introduced a binding rule with respect to the length of the summary: it should not be longer than 7 % of the full prospectus or 15 pages, whichever is the shorter.[30] The length of both the full and the summary prospectus nevertheless remain a concern. In the context of the Commission’s idea to create a “Capital Markets Union”,[31] the Prospectus Directive is under review. An important change in the proposal for a new Prospectus Regulation relates to the summary prospectus, which will be replaced by KIID-like standardized information document[32] of up to 6 A4 pages.[33] In the last stage of the legislative process, however, the European Parliament has added an exception, allowing the competent authority may authorize the issuer to draw up a longer summary of up to a maximum of 10 sides of A4-sized paper when printed, where the complexity of the issuer's activities, the nature of the issue, or the nature of the securities issued so requires and where there is a risk that the investor would be misled without the additional information being set out in the summary as a result.[34]

12. National initiatives for complex products. Until recently product information requirements were limited to the issue of transferable securities and UCITS funds. For other financial products, there were no harmonized information obligations. As a reaction to the losses suffered by retail investors during the crisis, many Member States felt that the existing regulatory toolbox did not suffice and toughened the rules, especially for complex products, the production of which had boomed in the build-up to the crisis.

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[26] Art. 8-9 and Annex I to Regulation (EU) 583/2010.

[27] Art. 5 (2) of the original Directive 2003/71/EC.

[28] Summaries were often simply a ‘cut-and-paste’ version of the prospectus and not simplified or recast to aid retail investor understanding. See N. Moloney, *EU Securities and Financial Markets Regulation* (OUP 2014) 98.

[29] Art. 5 (2) Prospectus Directive 2003/71/EC as amended.

[30] Art. 24 and Annex XXII of Regulation (EC) Nr. 809/2004 as amended by Regulation (EU) Nr. 486/2012.

[31] European Commission, ‘Green Paper - Building a Capital Markets Union’ (COM(2015) 63 final, 18 February 2015).

[32] The summary prospectus would actually be modeled as much as possible after the PRIIPs KID (see nr. 12 below). See Recital 25 of the Proposal for a Regulation of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading (30 November 2015, COM (2015)583 final).

[33] Art. 7 (3) of the Proposal. The exception allowing a summary prospectus of up to 10 A4 pages was added in the very last stage of the legislative process, upon amendment by the European Parliament.

[34] Amended article 7 (3) of the Proposal, as adopted by the European Parliament on 15 September 2017 (P8_TA-PROV(2016)0353).

The Dutch legislature was one of the frontrunners in this respect, introducing a "financial leaflet" ("financiële bijsluiter") for complex financial products as of 1 January 2007, with a risk label indicating the riskiness of the product in a visual manner.[35] The UK FSA (replaced by the FCA) followed with new rules in its Conduct of Business Sourcebook, requiring as from November 2007 that a firm must prepare a "key features document" for each packaged product,[36] cash-deposit Individual Savings Account (ISA) and cash-deposit Child Trust Fund (CTF) it produces, in accordance with a standardized scheme.[37] In 2011 the German Investor Protection and Capital Markets Improvement Act[38] introduced a section 31 (3a) into the German Securities Trading Act[39] requiring providers of financial instruments to make a short and easily understandable information document available to investors when engaging in investment advice.[40] Also insurers have the obligation to provide clients that are consumers with a product information document.[41] On 25 April 2014 a Belgian Royal Decree intended to introduce a KIID-like standardized information document for all financial "products" – including all saving, investment and insurance products),[42] with a risk label (inspired by the European energy label) indicating the riskiness of the product in a visual manner.[43] Its entry into force has however been postponed sine die[44] since the PRIIPs Regulation, which would introduce very similar obligations for a range of products also covered by the Royal Decree, had in the meanwhile been published in the Official Journal on 9 December 2014.

13. PRIIPs – KID. In view of the divergent approaches with regard to scope, content and format of those national product information requirements, European intervention became almost unavoidable. The PRIIPs Regulation introduces a mandatory "KID" ("Key Investor Document"), inspired by the UCITS KIID, for all "Retail Investment and Insurance Based Investment Products" ("PRIIPs").[45] The Regulation targets all "packaged" products, including investment (or mutual) funds,[46] investments packaged as life insurance products,[47] retail

[35] Art. 65 and following of the Decree of 12 October 2006 concerning rules on conduct of business supervision for financial institutions, (Besluit Gedragstoezicht financiële ondernemingen Wft).

[36] Defined as "(a) a life policy; (b) a unit in a regulated collective investment scheme; (c) an interest in an investment trust savings scheme; (d) a stakeholder pension scheme; (e) a personal pension scheme."

[37] FCA Handbook, COBS 13.1.1 and 14.2.1 (version 27 Oct 2015).

[38] Anlegerschutz- und Funktionsverbesserungsgesetz – AnsFuG.

[39] Wertpapierhandelsgesetz – WpHG.

[40] For transferable securities and UCITS this short information document can be replaced with the existing information obligations (prospectus and KIID). See also S. Andresen and U. Gerold, 'Key information document: PRIIPs Regulation - new, EU-wide standard for product information for consumers' (2 September 2015), www.bafin.be, published in German in the BaFIN Journal of August 2015, 31-36.

[41] Section 4 of the Regulation on Information Obligations for Insurance Contracts (Versicherungsvertragsgesetz-Informationspflichtenverordnung – VVG-InfoV).

[42] Art. 12, 39° of the law of 2 August 2002 on Financial Supervision.

[43] Royal Decree of 25 April 2014 approving the FSMA Regulation concerning the technical requirements of the risk label, *Belgian Official Gazette* 12 June 2014, 44567.

[44] Royal Decree of 2 June 2015, Belgian Official Gazette of 10 June 2015.

[45] A "packaged retail investment product" or "PRIP" is defined as "*an investment … where, regardless of the legal form of the investment, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the investor*" (art. 4(1) PRIIPs Regulation); an "Insurance-based investment product" is "*an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations*" (art. 4 (2) PRIIPs Regulation). See also nr. 15 below.

[46] For the time being UCITS funds are exempted, since they are already covered by the UCITS KIID. After a transitional period of 5 years, they will however become subject to the PRIIPs Regulation in the absence of any extension of the transitional period (recital 35, article 32 (1) and 33 (1) PRIIPs Regulation).

[47] Life insurance policies the return of which is based on the return of an underlying investment fund, are an important example of insurance-based investment products.

structured securities,[48] structured term deposits,[49] and all derivative products.[50] Like the UCITs KIID, the PRIIPs KID is a short standardized document of maximum three A4 pages, in which key information on the investment product should be provided in a clear and understandable language. Financial jargon as well as terminology which is not immediately clear to the retail investor should be avoided.[51] Prominent sections of the KID relate to the risk and return and the costs of the product. The PRIIPs Regulation sets forth the use of visual indicators to facilitate comprehension of the information provided in those sections.[52]

14. Conclusion. By introducing a KIID for UCITS funds, a KID for packaged products, and proposing a similar short information document for transferable securities, the European legislature explicitly intends to solve the above-mentioned problems of information overload and rational ignorance[53], as well as certain behavioural biases which undermine rational decision making by retail investors.[54]

Although those initiatives are therefore laudable, their effectiveness remains to be seen. For the new prospectus summary, which can be up to 6 A4 pages, and in exceptional circumstances even up to 10 A4 pages, the problem of information overload again most probably looms. For the PRIIPs KID, it proves very challenging to concretize the principles of the PRIIPs Regulation into rules which work for all the different types of PRIIPs. The European Parliament recently objected to the Commission Delegated Regulation, which introduced the details of the format of the KID and the classification methodology underlying the risk indicator, exactly because the it feared "*that the rules set out in the delegated regulation go against the spirit and aim of the legislation, which is to provide clear, comparable,*

[48] Structured securities are securities with an element of complexity, such as convertible bonds or bonds with a capital guarantee (third party guarantee or embedded option).

[49] Structured deposits are defined in article 4 (1) 43° of MiFID II as "*deposits*" in the meaning of art. 2 (1) c) of Deposit Guarantee Directive 2014/49/EU (i.e. "*a credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution is required to repay under the legal and contractual conditions applicable, including a fixed-term deposit and a savings deposit*"), which are "*fully repayable at maturity on terms under which interest or a premium will be paid or is at risk, according to a formula*" involving certain underlying financial instruments or indexes. The reference to the Deposit Guarantee Directive should actually read art. 2 (1) 3°.

[50] See for an indicative list of PRIIPs: ESMA, EBA and EIOPA, Discussion Paper: Key Information Documents for Packaged Retail and Insurance-Based Investment Products (PRIIPs) (JC/DP/2014/02, 17 November 2014) at 12-14. For a detailed discussion of the scope of the PRIIPs Regulation, see V. Colaert, 'Regulation of PRIIPs: Great ambitions, insurmountable challenges?' (2016) Journal of Financial Regulation 2 (2), 203-224.

[51] Art. 6(1) and (4) PRIIPs Regulation.

[52] Art. 8 (3) (d) (i) and (f) PRIIPs Regulation.

[53] Recital 15 of the PRIIPs Regulation states that "*unless the information is short and concise there is a risk that [retail investors] will not use it*."

[54] Art. 8 (3) b) of the PRIIPs Regulation for instance requires that "a comprehension alert" should be inserted in the KID: *"you are about to purchase a product that is not simple and may be difficult to understand*", amongst other things if the investment's pay-off takes advantage of a retail investor's behavioural biases, such as a teaser rate followed by a much higher floating conditional rate, or an iterative formula (recital 18 of the PRIIPs Regulation). Such teaser rates make use of a bias known as hyperbolic discounting, a tendency to opt for a smaller immediate reward over a larger reward in the (far) future. See also: Joint Committee of the European Supervisory Authorities (JC/DP/2014/02) (note 50) at 17: "*Research into consumer behaviour in investment decision making has also shown the detrimental effects of behavioural biases. For instance, retail investors often tend to focus more on the 'reward' or 'performance scenarios' of an investment product than the effect of costs, or to overvalue immediate rewards or risks, over long term rewards or risks. Given this, a traditional approach to disclosures focused solely on information and with little regard to its presentation, is being superseded in policy making by an approach that is more informed by insights into consumer behaviours." … "consumer testing … will be used to select options on the basis of how consumers react in terms of comprehension, comparability and 'engagement' (salience)*".

understandable and non-misleading information on PRIIPs to retail investors".[55] A related and even more fundamental problem came to the surface in a large consumer testing survey, testing different possible formats for the PRIIPs KID. The study came to the staggering conclusion that even when the best performing design of indicators and KID was used, a large group of retail investors still did not succeed in drawing correct conclusions from the information provided.[56] It all goes to show that that even if information is presented in a format and using terminology and visual indicators as simple as the European legislature could think of, a large group of retail investors are still not able to draw correct conclusions from this information and many of them will prefer to be guided by other sources.[57]

Even improved information obligations indeed cannot deal with certain biases, such as for instance overconfidence or herd behaviour. Such biases undermine the utility of disclosure and education: they have as an effect that even if consumers are well-informed, "*financial literacy does not always translate into good financial behavior*".[58] Drivers other than "independent printed material" influence retail investors' decision making to a much higher extent. Advisors and the opinion of family and friends have been shown to be key influencing factors in investor decision-making.[59]

Also the legislator has understood that the "caveat emptor" principle, underpinned and reinforced by the information paradigm, has reached its limits in the financial services sector. Product information is today indeed only one building block of investor protection, which is increasingly complemented with the two other building blocks (see sections II. and III.).

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[55] The European Parliament more specifically (i) deemed misleading to investors to remove credit risk from the calculation of risk categorisation of insurance products; (ii) required further clarification of the treatment of multi-option products, in particular in relation to the explicit exemption granted to UCITS funds under Regulation (EU) No 1286/2014; (iii) points at flaws in the methodology for the calculation of future performance scenarios, which would, in particular, not show for some PRIIPS, even in the adverse scenario, and even for products which have regularly led to losses over the recommended minimum holding period, that investors could lose money; (iv) denounces the lack of detailed guidance on the 'comprehension alert', which would create a serious risk of inconsistent implementation of this element in the key information document across the single market, being of the opinion that further standardisation of when the comprehension alert will be used should be introduced as an additional RTS mandate. See: European Parliament, Objection to a delegated act – Resolution on the Commission delegated regulation of 30 June 2016 supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents (C(2016)03999–2016/2816(DEA), (P8_TA(2016)0347, 14 September 2016).

[56] London Economics and Ipsos (note 19).

[57] For a critical appraisal, see: Colaert, 'Regulation of PRIIPs' (note 50) at 218-219.

[58] S. Ambuehl, B.D. Bernheim and A. Lusardi, 'The effect of financial education on the quality of decision making' (NBER Working Paper 20618, October 2014); European Parliament, 'Consumer Protection Aspects of Financial Services' (IP/A/IMCO/ST/2013-07, February 2014) at 95, with further references. O. Ben-Shahar and C.E. Schneider, 'The Failure of Mandated Disclosure' (2010) 159 *University of Pennsylvania Law Review* 659, 704-728. In particular, those individuals who have the highest propensity to instantaneous gratification are likely to benefit the least from education or disclosure of information, as they will be least capable of investing the necessary time (see John Armour *et al*, *Principles of Financial Regulation* (Oxford, OUP 2016) 218. Also Avgouleas (note 3) at 457.

[59] E.g. Investor Education Fund, 'Investor behaviour and beliefs: Advisor relationships and investor decision-making study' (The Brondesbury Group 2012) 21. This study found the second source of information for decisions to be the opinion of selected family and friends. "Independent printed material" was only the third source of information for decisions. See also Decision Technology Ltd (note 14) at 41: "*Further, a large cross-country survey in Europe showed that close to 90 percent of respondents in several countries specifically expect financial institutions to provide advice, and the vast majority of customers say that they trust the advice they receive*".

2. A more horizontal approach

15. Cross-sectoral scope of legislation on information documents. Until recently financial regulation was usually sectorally divided along the lines of the three traditional sectors of the financial industry: banking regulation, securities and financial markets regulation and insurance regulation. A second evolution that can be observed in several of the national initiatives described above, as well as in the PRIIPs Regulation, is that their scope of application is no longer limited to one sector, but reaches out to a range of products with similar features (often "complexity") irrespective of the traditional sector to which the product belongs.[60]

The PRIIPs Regulation for instance targets all "Retail Investment and Insurance Based Investment Products" ("PRIIPs").[61] It has a horizontal approach in that it targets complex products with similar features, irrespective of the formal qualification of the product as a banking, securities or insurance product. It thus covers complex products which are part of (i) the banking sector, such as structured term deposits; (ii) the investment sector, such as retail structured securities and investment (or mutual) funds; and (iii) the insurance sector, such as investments packaged as life insurance policies.

We have argued in a previous contribution that, if the PRIIPs regulation wants to achieve its goals of easily accessible information and comparability of substitute products, its scope of application is still too limited and should include (at least) also simple deposits and simple securities.[62] Even though the proposal for a Prospectus Regulation does attempt to design the new summary prospectus to the example of the PRIIPs KID, it remains to be seen whether this will result in a true level playing field. A true horizontal approach would moreover require that also the look and feel of other initiatives featuring standardized information documents in the financial sector would be scrutinized from this perspective. It might indeed be a good idea to remove unsubstantiated differences between standardized information sheets in a wider domain (e.g. non-life insurance products[63], consumer credit[64], mortgage credit[65]). Even if differentiation will remain necessary in view of the particularities of those products, using a highly similar format would increase the familiarity of retail customers with this type of information documents.

II. Service quality requirements (conduct of business rules)

A. Background

16. Context. Retail investors will typically approach the financial markets via an intermediary, either because they have no other option – as they do not have direct access to the venue where the instrument is traded and need to make use of the service "order execution"[66] – or

[60] The author has developed this idea in more detail in another contribution. See: V. Colaert, 'European Banking, Securities and Insurance Law: Cutting through Sectoral Lines?' (2015) 6 CML Rev, 1579-1616.
[61] See footnote 45.
[62] V. Colaert, 'Regulation of PRIIPs' (note 50) at 208-210.
[63] Art. 20 (8) and (9) IDD requires EIOPA to develop draft implementing technical standards regarding a standardised presentation format of the insurance product information document specifying presentation details.
[64] Standard European Consumer Credit Information (art. 5 and Annex II of Consumer Credit Directive 2008/48/EC).
[65] European Standardised Information Sheet (ESIS) (art. 14 (2) and Annex II of Mortgage Credit Directive 2014/17/EU).
[66] "Execution of orders on behalf of clients' means acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients and includes the conclusion of agreements to sell

because they want the help from a professional party in making an investment decision (typically via investment advice[67] or portfolio management[68]). Because of their growing importance and the trust many investors put on those intermediaries, those intermediaries however also pose risks from an investor protection perspective.[69] All too often those intermediaries distribute, advise to buy or buy products on behalf of their clients, which are not necessarily the best choice for the client, and may even rather represent a favourable deal for the intermediary.[70] A growing body of conduct of business rules has been introduced to contain the risks involved with the provision of investment services.

17. Definition. "Conduct of business rules" can be defined as a range of "principles of conduct which should govern the activities of financial services firms in protecting the interest of their customers and the integrity of the market".[71] They are, in other words, rules that should ensure that the services provided by a financial institution to investors meet certain quality standards.

18. Legal environment. The EU conduct of business regime is currently mainly governed by MiFID II 2014/65/EU and its implementing standards, which apply to all investment firms, credit institutions and UCITS management firms (hereafter commonly referred to as 'financial institutions') when providing investment services or ancillary services. The Insurance Distribution Directive (IDD) has introduced very similar conduct of business rules for insurance firms and insurance intermediaries distributing insurance based investment products (such as certain life insurance products, infra, nr. 27).

19. Overview. The basis of the conduct of business rules is an encompassing fiduciary duty (also referred to as a duty of loyalty or a duty of care) for the services provider to act "honestly, fairly and professionally in accordance with the best interests of its clients".[72] This general duty is both an umbrella principle, which has been further developed in a range of more detailed conduct of business rules[73] and a catch all principle, ensuring that conduct which is

financial instruments issued by an investment firm or a credit institution at the moment of their issuance (art. 4 (1) 5° MiFID II).

[67] "Investment advice means the provision of personal recommendations to a client, either upon the client's request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments" (art. 4 (1) 4°] MiFID II).

[68] "Portfolio management means managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments" (art. 4 (1) 8° MiFID II).

[69] See e.g. Grundmann and Kerber (note 14) at 271 (principal-agent problems); L. ENRIQUES, 'Conflicts of Interest in Investment Services' in G. FERRARINI and E. WYMEERSCH, *Investor Protection in Europe, Corporate Law Making, the MiFID and Beyond* (Oxford: OUP 2006) 321-338; with respect to best execution: Paredes (note 12) at 1466, footnote 325.

[70] Such behaviour often goes unnoticed or unsanctioned, since investors will typically not be able to determine whether their "less-than-expected" performance is due to risks they intended to take under the contract or to poor advice from the advisor regarding the selection of the contract. See John Armour et al., *Principles of Financial Regulation* (Oxford, OUP 2016) 2016.

[71] IOSCO, 'International Conduct of Business Principles' (July 1990) nr. 18. See also E. Avgouleas, 'The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection' (2000) *ELJ* 74; C. Cruickshank, 'Is there a Need to Harmonise Conduct of Business Rules?' in G. Ferrarini (ed.), *European Securities Markets. The Investment Services Directive and Beyond* (Kluwer Law International 1998) 131.

[72] Art. 24 (1) MiFID II.

[73] Art. 24 (1) in fine and art. 24-25 MiFID II.

not regulated in more detail by specific conduct of business rules, is still covered by this general fiduciary duty.

A large part of the more specific conduct of business rules are again information obligations. Part of the service of investment services providers is indeed to channel product information to the client. If a product information document is or should be available, the services provider is obliged to provide this document in good time before the retail investor is bound by any contract or offer relating to that product (PRIIPs KID or UCITS KII)[74] or to inform the (potential) client where it is made available to the public (prospectus for transferable securities).[75] In certain instances the services provider will also process the product information for the benefit of the client in order to ensure that the client would invest in products which suit his or her investment profile (if investment advice or portfolio management is provided)[76] or to warn against inappropriate decisions (e.g. if orders are executed in respect of complex products).[77] Investment services providers therefore play an important role as "information intermediaries".[78] They moreover have to provide pre-contractual information (i) on the investment services provider and its services, (ii) on the risks of products and investment strategies, (iii) on the costs and related charges of products and services and (iv) on execution venues.[79] The conduct of business obligations further feature post-transactional reporting obligations.[80] With respect to all those information obligations, information quality requirements apply (clear and not-misleading).[81]

In view of the above-mentioned problems (i) that investors do not always read, absorb or correctly process the available information and (ii) that financial intermediaries may not always act in the best interest of the client, the conduct of business rules also include more "substantive" quality measures. Know-your-customer rules require that (i) the investment services providers providing investment advice or portfolio management only do so on the basis of good knowledge, not only of the product, but also of client. If investment advice or portfolio management is provided, the services provider will check the client's investment objectives, financial situation and knowledge and experience (suitability test).[82] If the service consists of merely executing client orders, the services provider will in principle[83] still check whether such order is appropriate for the client in view of the knowledge and experience of

[74] Art. 13 PRIIPs Regulation; article 80 (2) UCITS Directive.

[75] Art. 48 (3) MiFID II Delegated Regulation. See also art. 14 – especially 14 (7) – of the Prospectus Directive 2003/71/EC, requiring that where the prospectus is made available by publication in electronic form, a paper copy must nevertheless be delivered to the investor, upon his request and free of charge, by the issuer, the offeror, the person asking for admission to trading or the financial intermediaries placing or selling the securities. Recital 73 of the MiFID II Delegated Regulation clarifies that the provision by an investment firm to a client of a copy of a prospectus that has been drawn up and published in accordance with Directive 2003/71/EC, should not be treated as the provision by the firm of information to a client for the purposes of the operating conditions under Directive 2014/65/EU which relate to the quality and contents of such information, if the firm is not responsible under that Directive for the information given in the prospectus.

[76] Suitability test (art. 25 (2) MiFID II), see also the following paragraph of this contribution.

[77] Appropriateness test (art. 25 (3) MiFID II), see also the following paragraph of this contribution.

[78] Certain authors have even argued for "mandatory information intermediaries" (See Hadfield, Howse and Trebilcock (note 4) at 161) and for "Information Intermediaries as an additional market solution" (Grundmann and Kerber (note 14) at 267).

[79] Art. 24 (4) MiFID II.

[80] Art. 25 (6) MiFID II.

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

[82] See footnote 76.

[83] In certain circumstances the services provider will not have to perform this appropriateness test. See art. 25 (4) MiFID II.

that client with such product.[84] The best execution requirement obliges the investment services provider to take all reasonable steps and establish procedures per type of financial instrument to consistently execute orders on terms most favourable to the client.[85] Finally, one of the most controversial rules to avoid services providers pursuing their own interests rather than the best interests of their client, is a ban on inducements, prohibiting that a services provider would grant or obtain a fee or non-monetary benefit to or from a third party in relation to the service to the client.[86]

B. Recent trends

1. Increasing detail

20. From ISD to MiFID II. This second building block of European investor protection is much more recent. After a 1977 Recommendation of the European Commission recommended the introduction of a number of basic conduct of business rules,[87] the UK was the first to introduce a comprehensive set of conduct of business rules in 1986,[88] followed by other Member States in the next years.[89] In 1990 IOSCO issued its first "Conduct of Business Principles".[90] In 1993 the Investment Services Directive (ISD) was introduced in order to ensure that the same principles would underlie the conduct of business standards in each Member State. ISD indeed merely aimed at minimum harmonization, setting out seven high-level principles, which had to be developed in more detailed conduct of business rules by the Member States.[91] Some Member States, such as the UK[92] and the Netherlands,[93] indeed introduced an elaborate national regime of conduct of business rules. Other Member States, such as Belgium, did little more than copying the ISD principles into national law.[94] In 2004, in order to level the resulting uneven playing field, the "Markets in Financial Instruments Directive" ("MiFID")[95] and its

[84] See footnote 77.
[85] Art. 27 MiFID II.
[86] Art. 24 (7) b, (8) and (9) MiFID II.
[87] Recommendation 77/534/EEC, *OJ* L 212/37, especially General Principles 5-6 and Supplementary Principles 1-6.
[88] Financial Services Act 1986 (chapter 4). See D. Walker, 'The development of principles and conduct of business rules for financial services in the UK' (1990) Revue de la Banque/Bank- en Financiewezen, 371.
[89] See e.g. for France: Commission des Operations de Bourse, 'Rapport général du groupe de déontologie des activités financières', *Supplément au Bulletin Mensuel* n° 212 (March 1988) 81 p ; Commission des Opérations de bourse, 'Bilan de l'application des propositions du groupe présidé par M. Gilles Brac de la Perrière', Supplément au Bulletin mensuel N° 228 (September 1989) 77p; Belgium: Act of 4 December 1990 on financial markets and financial transactions, and the implementing Royal Decree of 5 August 1991. In Germany codes of conduct for the investment and finance business under state supervision were not considered to be a realistic possibility before the ISD (see Klaus Hopt, 'Self-Regulation in Banking and Finance – Practice and Theory in Germany' in *The ethical standards in banking and finance* (Brussels 1998) at 65.
[90] IOSCO, 'International Conduct of Business Principles' (July 1990) 11 p.
[91] Art. 11 of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ L 141, 27 (Investment Services Directive or "ISD"). Moreover, although the ISD introduced a European passport for investment firms on the basis of home state control, the conduct of business rules remained under host state control, requiring investment firms providing cross-border services, to adapt to the host state's implementation of the conduct of business standards. See art. 11 ISD and M.G. Warren III, 'The European Union's Investment Services Directive' (1995) 15 Journal of International Law at 207.
[92] Financial Services Act (1986) and implementing decrees and standards.
[93] Wet Toezicht Effectenverkeer 1995 and implementing decrees and standards.
[94] Art. 36 of the Act of 6 April 1995 on the statute and supervision of investment firms.
[95] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30 April 2004.

Implementing Directive[96] replaced the ISD minimum standards with fully fledged and detailed conduct of business rules. Those have been fine-tuned and elaborated even further - both in detail and in number of rules - by MiFID II and its implementing standards.[97]

A first, very evident trend in this building block is clearly that the conduct of business rules become ever more detailed and complex. The most prominent examples are briefly set out below.

21. Investment advice. Under MiFID, investment advice had been given a very prominent place already: it was upgraded from an ancillary service in ISD to an investment service[98], it was defined very precisely in the MiFID and the Implementing Directive[99] and CESR (today transformed into ESMA)[100] developed a 5-step test for determining whether a certain action can be qualified as investment advice.[101] MiFID II keeps the MiFID I definitions largely unchanged,[102] but adds a new layer by distinguishing between (limited) investment advice and "independent investment advice", which needs to comply with a more stringent conduct of business regime. Whereas the MiFID II rules for limited investment advice correspond to the MiFID I conduct of business rules for investment advice, additional conduct of business rules apply in respect of "independent" investment advice, including requirements on the range of products considered in providing personal recommendations and an stricter ban on inducements than for limited investment advice (on inducements, see the following paragraph).[103] In line with this new distinction, also new information obligations regarding investment advice have been introduced.[104]

22. Inducements. Although ISD already featured a very general conflict of interests rule,[105] the specific problem of fees or non-monetary benefits received or paid by the services provider in relation to the service for the client, which may induce the services provider to

[96] Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241, 2 September 2006.
[97] Recital 70 MiFID II 2014/65/EU.
[98] See recital 3 and Annex I, A to MiFID 2004/39/EC.
[99] Art. 4 (1) 4° MiFID and art. 52 Implementing Directive.
[100] CESR stands for 'Committee of European Securities Regulators'. It was replaced in 2011 by the European Securities and Markets Authority, ESMA.
[101] CESR, 'Q&A – Understanding the definition of advice under MiFID' (CESR/10-293).
[102] See the general definition of "investment advice" in art. 4 (1) 4° MiFID II and art. 9 of the proposal for a Commission Delegated Regulation of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organizational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (C(2016) 2398 final).
[103] Art. 24 (7) MiFID II and art. 53 of the proposal for a Commission Delegated Regulation (C(2016) 2398 final) (note 107). See on this new distinction and the specific conduct of business rules applying to independent advice on the one hand and to limited advice on the other hand: Paolo Giudici, 'Independent Financial Advice' and Larissa Silverentand Jasha Sprecher and Lisette Simons, 'Inducements', both in D. Busch and G. Ferrarini, *Regulation of the EU Financial Markets: MiFID II and MiFIR* (Oxford: Oxford University Press 2016).
[104] Art. 24 (4) MiFID II: The financial institution providing investment advice should in good time before it provides investment advice, inform the client: (i) whether or not the advice is provided on an independent basis; (ii) whether the advice is based on a broad or on a more restricted analysis of different types of financial instruments and, in particular, whether the range is limited to financial instruments issued or provided by entities having close links with the investment firm or any other legal or economic relationships, such as contractual relationships, so close as to pose a risk of impairing the independent basis of the advice provided; (iii) whether the investment firm will provide the client with a periodic assessment of the suitability of the financial instruments recommended to that client. See also art. 52 of the proposal for a Commission Delegated Regulation (C(2016) 2398 final) (note 102).
[105] Art. 10 (1), fifth bullet and art. 11 (1), sixth bullet.

serve other interests than their clients' ("inducements"), was not regulated. One of the most controversial investor protection measures introduced by MiFID I, was the introduction of a ban on inducements. The ban however featured a number of exceptions, which were interpreted quite largely.[106] MiFID II has further elaborated and refined the inducements regime. An inducements regime highly similar to the MiFID I regime applies to most investment services (including order execution).[107] With respect to portfolio management and independent investment advice, however, a much stricter ban on inducements applies.[108]

23. Information obligations. ISD featured a general obligation to provide "adequate disclosure of relevant material information in its dealings with its clients".[109] MiFID I introduced a much more detailed range of information requirements, including information on the investment firm and its services, financial instruments and proposed investment strategies and associated risks, execution venues, and costs and associated charges.[110] MiFID II not only further details those information obligations – especially information on costs and charges[111] – but also adopts several new information obligations. In relation to the concept of "independent advice", services providers will now have to inform their clients on whether advice is independent or not, and, if the case may be, on the range of financial instruments which the independent investment advisor assesses. New information obligations have further been introduced on the offer of products and services as a package.[112]

2. Increased cooperation between services provider and product manufacturer

24. In relation to information obligations. Before the introduction of MiFID II, the obligations of the product manufacturer on the one hand and of the services provider on the other hand,

[106] Art. 26 MiFID Implementing Directive 2006/73/EC allowed inducements (i) which are paid or provided to or by the client; or (ii) which are designed to enhance the quality of the service for the client and are disclosed to the client; or (iii) which are proper fees, which enable or are necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot give rise to conflicts of interests. Recital 39 of this Directive provided that "the receipt by an investment firm of a commission in connection with investment advice or general recommendations, in circumstances where the advice or recommendations are not biased as a result of the receipt of commission, should be considered as designed to enhance the quality of the investment advice to the client." CESR added to this that this recital should not be interpreted exhaustively and does not prohibit other distribution arrangements under which an investment firm receives a commission (from, for example, a product provider or issuer) without giving investment advice or general recommendations. For these cases, payments can be seen as being designed to enhance the quality of the service to the client by allowing a given investment service to be performed over a wider range of financial instruments. (CESR, 'Inducements under MiFID – Recommendations' (CESR/07-228, April 2007) at 12, recommendation 5 (b)). In this way a very broad exception to the ban on inducements was created.

[107] Art. 24 (9) MiFID II 2014/65/EU.

[108] Art. 24 (7) b) and 24(8) MiFID II. Only three very limited exceptions apply: (i) small non-monetary benefits; (ii) "accept and not retain third party payments", i.e. inducements returned to the client as soon as possible after receipt, by transferring the monies received to the client money account; (ii) fees, commissions or non-monetary benefits paid or provided by a person on behalf of the client.

[109] Art. 11, fifth bullet ISD.

[110] Art. 19 (3) MiFID, elaborated in much detail by art. 30-34 MiFID Implementing Directive 2006/73/EC.

[111] Art. 24 (4) MiFID II; art. 50 of the Proposal for a MiFID II Delegated Regulation (C(2016) 2398 final) (note 107). See on the relationship between PRIIPs, UCITS and MiFID II information obligations: V. Colaert, 'MiFID II in relation to other investor protection regulation: Picking up the crumbs of a piecemeal approach' in D. Busch and G. Ferrarini, *Regulation of the EU Financial Markets: MiFID II and MiFIR* (Oxford: OUP, 2016).

[112] Art. 24 (11) MiFID II. See also V. Colaert, 'Cross-selling practices in the financial sector: Who's cross to bear?' (KU Leuven Working Paper 2017, available via ssrn).

were two completely separate responsibilities.[113] MiFID II, however, requires cooperation between services provider and product manufacturer in order to provide full information on costs and associated charges to the client. MiFID II indeed requires the services provider to provide information not only on the costs and associated charges of the services, but also – in most instances[114] - of the product. If a product document (KID, KIID or prospectus) is available which features such information, the services provider may rely on such information. If no such document is available or if such document does not include certain information which the services provider should provide to the client according to MiFID II, the services provider needs to liaise with the product manufacturer to obtain such information and pass it through to the client. Although increased interaction between product providers and distributors should in principle be regarded as a positive evolution, it may be problematic that MiFID II places the responsibility of gathering missing product information upon the services provider. Obtaining this information may not be a big issue for large services providers with sufficient bargaining power, but for smaller services providers this may prove quite a challenge. If they fail to meet this challenge, their only option may be to cease distribution of the product in question.[115]

3. Widening scope of application

25. Limited scope of application of MiFID I. A second evolution with respect to conduct of business rules is that their scope of application widens. ISD and MiFID I applied to the provision of "investment services"[116] or "ancillary services"[117] relating to "financial instruments". Financial instruments are defined as an exhaustive list, including transferable securities[118], money-market instruments[119], units in collective investment undertakings, and different kinds of derivative contracts.[120] Not covered by MiFID I were, among other things, deposits and insurance products.

It has however been shown that, after the entry into force of MiFID I, mutual funds were often wrapped as life insurance products or as structured deposits in order to avoid the MiFID-

[113] The MiFID Implementing Directive 2006/73/EC explicitly states that the UCITS simplified Directive is to be regarded as appropriate information for purposes of the MiFID information requirements on costs and risks of UCITS funds (see recitals 52, 54 and 55 and article 34 (1) and (2) of the MiFID Implementing Directive).

[114] Art. 50 (5) and (8) of the proposal for a MiFID II Delegated Regulation (C(2016) 2398 final) (note 107) requires the services provider to provide full ex ante and ex post disclosure on the costs and associated charges related to both the financial instrument and the service, if (i) the investment firm recommends or markets financial instruments to clients; or (ii) the investment firm providing any investment services is required to provide clients with a UCITS KIID or PRIIPs KID in relation to the relevant financial instruments.

[115] Art. 50 (4) and 510 of the Proposal for a MiFID Delegated Regulation (C(2016) 2398 final) (note 107). We have criticized this approach in an earlier contribution as representing an almost unsurmountable challenge, especially for smaller services providers, see Colaert, 'MiFID II in relation to other investor protection regulation' (note 116), para 21.34.

[116] Such as portfolio management, investment advice and order execution. See the full list of investment services in Annex I.A of MiFID I.

[117] Such as safekeeping and administration of financial instruments for the account of clients. See the full list of ancillary services in Annex I.B of MiFID I. Under ISD they were called "non core services" (Annex, Section C to the ISD).

[118] See definition in art. 4 (1) 18° MiFID I.

[119] See definition in art. art. 4 (1) 19 MiFID I.

[120] See annex I, C MiFID I. MiFID I added a whole range of derivative products to the ISD list of financial instruments.

regime.[121] This tendency to structure a product not to meet economic needs or investor preferences, but merely in order to circumvent certain legislation is an instance of "regulatory arbitrage".[122]

26. Member States' reaction. Many Member States therefore soon deemed the scope of application of MiFID I too limited and provided for national extensions of the MiFID rules to certain insurance products and/or structured deposits, or even duplicated MiFID-like rules into their insurance law. In the UK the "Conduct of Business Sourcebook" applies, as of 1 November 2009 to firms with respect to the following activities: designated investment business and long-term insurance business in relation to life policies, and activities connected with them.[123] In France since 2010 insurance companies and insurance intermediaries distributing life insurance policies should apply rules which are very much inspired by the MiFID conduct of business rules[124] "*in order to "harmonise certain rules regarding the marketing of financial instruments with those applicable to the marketing of comparable savings and insurance products*".[125] The French Autorité de Contrôle Prudentiel has moreover made recommendations with respect to the marketing of term deposits, which resemble some of the MiFID conduct of business rules.[126] Also the Belgian legislator broadened the scope of its conduct of business rules to the insurance sector,[127] not only to insurance based investment products (such as certain life insurance products) but also to traditional indemnity insurance contracts.[128]

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[121] See for concrete examples: N. Moloney, *EU Securities and Financial Markets Regulation* (OUP 2014) at 780, footnote 71; European Commission, 'Open Hearing on Retail Investment Products' (2008) at 11, indicating that in France, sales of unit-linked life insurance have increased following the implementation of MiFID; see also at 17, where several examples of regulatory arbitrage in the Netherlands are given, and at 16, where Eddy Wymeersch, chairman of CESR at the time, argued that regulatory arbitrage has been seen on a massive scale through the growth of the certificate market.

[122] J. Kremers, D. Schoenmakers and P. Wierts, 'Cross-sector supervision: Which model?' in Herring and Litan (eds.), Brookings-Wharton Papers on Financial Services (Brookings Institution Press, 2003), 241.

[123] COBS 1.1.1.

[124] See e.g. the "non-misleading information" and "Know your customer requirements" for the distribution of life insurance products: Art. L.132-27 and L.132.27-1 Code des assurances (for insurance companies); Art. L.520-1 III du Code des assurances (for insurance intermediaries). With respect to know your customer requirements, the Autorité de Contrôle Prudentiel has come up with a recommendation inspired on important aspects of the ESMA guidelines on suitability ((ESMA/2012/387). See: Autorité de Contrôle Prudentiel, 'Recommendation on gathering customer information in the framework of the duty to provide advice on life insurance policies' (2013-R-01).

[125] Art. 152, 3° of the Loi n° 2008-776 du 4 août 2008 de modernisation de l'économie. This Act has been implemented by two 'Ordonnances' with relevance for this contribution: (i) Ordonnance n° 2008-1271 du 5 décembre 2008 relative à la mise en place de codes de conduite et de conventions régissant les rapports entre les producteurs et les distributeurs, en matière de commercialisation d'instruments financiers, de produits d'épargne et d'assurance sur la vie, made changes to (inter alia) the Code des Assurances, and entered into force on 1 January 2010; (ii) Ordonnance n° 2009-106 du 30 janvier 2009 portant sur la commercialisation des produits d'assurance sur la vie et sur des opérations de prévoyance collective et d'assurance, made changes to the Code des Assurances, and entered into force on 1 July 2010.

[126] Autorité de Contrôle Prudentiel, 'Recommendation on the marketing of time deposit accounts' (2012-R-02).

[127] Law of 30 July 2013 reinforcing the protection of the investor in financial products and services and the competences of the FSMA and three Royal Decrees of 21 February 2014, *Belgian Official Gazette* 7 March 2014, 20133, 20144 and 20158.

[128] Royal Decree of 21 February 2014 with respect to the rules on the application of articles 27 to 28bis of the law of 2 August 2002 to the insurance sector. The concrete translation of the MiFID conduct of business rules for the insurance sector however differentiates between insurance-based investment products on the one hand and indemnity insurance contracts on the other. Title II, Chapter 4 of the Royal Decree of 21 February 2014 with respect to the rules of conduct and rules on the management of conflicts of interests for the insurance sector,

27. EU reaction – MiFID II and IDD. Again this Member State evolution has been consolidated and harmonized at EU level. First, compared to MiFID I, MiFID II has (partly) expanded the scope of application of the conduct of business rules to structured deposits.[129]

Conduct of business rules for insurance products were at EU-level already covered by Insurance Mediation Directive 2002/92/EC (IMD), which however merely provided for some basic information obligations and a requirement to perform a need analysis for the client.[130] In order to avoid regulatory arbitrage between products subject to MiFID II conduct of business rules and insurance-based investment products which only needed to comply with the much lighter IMD regime, MiFID II has amended the IMD by introducing into IMD a separate chapter with "MiFID-like" conflict of interest and conduct of business rules for insurance-based investment products.[131] In the mean while the IMD has been fully replaced by the "Insurance Distribution Directive" ("IDD").[132] The conduct of business rules in the IDD have been aligned to MIFID II to a much greater extent,[133] although important, many unsubstantiated differences remain.[134]

28. Further widening the scope? MiFID conduct of business rules have proved to be an inspiration for the wider domain of financial services. Apart from the conduct of business rules for insurance-based investment products, the IDD also features conduct of business rules for non-life insurance products, which are inspired by the MiFID II conduct of business rules, although not so much as the rules for insurance-based investment services. At a national level, the Belgian legislator has introduced conduct of business rules for a newly regulated financial service, "financial planning"[135], in 2014.[136] Although clearly inspired by MiFID I, the conduct of business rules have obviously been adapted to the particularities of financial planning. The conduct of business rules include a general duty of care, an information quality requirement (clear, correct and not misleading) and information requirements[137], a requirement to enter into a written agreement (minimum terms and conditions of which have been set forth in the

applies to saving and investment insurance contracts, whereas title II, Chapter 3 applies to other insurance contracts.

[129] Article 1, § 4 of MIFID II. Structured deposits are defined in article 4 (1) 43° (see footnote 49).

[130] Art. 12-13 IMD.

[131] Article 91 MiFID II Directive.

[132] This new name expresses the fact that the IDD rules no longer only applies to insurance brokers or intermediaries ("mediation"), but also to insurance companies that engage in direct selling, and thus to anyone distributing insurance products. See European Commission, 'Press Release - Commission welcomes deal to improve consumer protection for insurance Products' (IP/15/5293 July 2015).

[133] See: Explanatory memorandum to the IMD II-proposal (COM(2012)360) at 2: "In order to ensure cross-sectoral consistency, the European Parliament requested that the revision of IMD1 would take into account the ongoing revision of the Markets in Financial Instruments Directive (MiFID II). This means that, whenever the regulation of selling practices of life insurance products with investment elements is concerned, the proposal for a revised Directive (IMD2) should meet the same consumer protection standards as MiFID II". See also at 11.

[134] See: Colaert, 'MiFID II in relation to other investor protection regulation' (note 111), paragraphs 21.07-21.26.

[135] Advice on the optimization of the structure, planning in time, protection, legal organization or transfer of wealth of a retail client, on the basis of the needs and objectives indicated by the client (art. 4 § 1 of the law on financial planning of 25 April 2014). It should not be confused with investment advice. In the context of advice on financial planning, it is prohibited to give advice on transactions in specific financial instruments (Explanatory memorandum to the proposal for a law of 14 February 2014, *Parl. St*. Kamer, Doc 53, nr. 3394/001, 11).

[136] Law on financial planning of 25 April 2014 on the statute and the supervision of independent financial planners and on the provision of advice on financial planning by regulated entities, *Belgian Official Gazette* 27 May 2014 and Royal Decree of 8 July 2014, *Belgian Official Gazette* 18 August 2014, 60563.

[137] Art. 25-26 of the law and art. 12 of the Royal Decree.

law) and a reporting obligation.[138] There is also a know-your-customer requirement, the adaptation of which to the specificities of financial planning is the most obvious.[139]

If the wider field of financial services is considered, the (at the EU level) recent emphasis on responsible lending, first in the Consumer Credit Directive[140] and subsequently in the Mortgage Credit Directive[141], can also be regarded as an instance of the tendency to require financial services providers to assist their clients in taking rational decisions.[142]

It raises the question whether the legislator should not develop general consumer protection principles for the financial sector as a whole, possibly as part of general consumer protection legislation (e.g. unfair commercial practices directive[143]; unfair contract terms directive[144]). Today the articulation between conduct of business rules and general consumer protection rules is often not clear and difficult to disentangle.[145]

III. Product Regulation

A. Background

29. Context. In line with the information paradigm, the credo of the European legislator has traditionally been: all products, even junk products, can be created and marketed, as long as sufficient, clear and understandable information is published to allow investors to take a rational decision on whether to invest in such products and at what price. In contrast with traditional consumer law, where minimum product quality requirements are legion, product regulation in the financial industry was deemed an unnecessary impediment to market innovation.

30. UCITS. For a long while, the only instance of EU product regulation was the UCITS Directive.[146] It regulates the conditions which an investment fund should fulfill in order to allow the use of the label "UCITS"-fund and marketing in the entire EU on the basis of a home state license.[147] The UCITS Directive however does not ban other investment funds which did

[138] Art. 30.

[139] The information which should be obtained should relate to the personal situation of the client (including his financial, family and professional situation) and his objectives and needs with respect to financial planning (art. 29 § 3).

[140] Art. 8 of Consumer Credit Directive 2008/48/EC.

[141] Art. 18 of Mortgage Credit Directive 2014/17/EU.

[142] See also: European Commission, 'Green paper on retail financial services: Better products, more choice, and greater opportunities for consumers and businesses' (10 December 2015, COM(2015)630 final) at 3, considering those different financial services in similar terms ("increased transparency requirements, and better advice in some areas, before the sale of certain financial products such as payments accounts, consumer and mortgage credit, investment products and insurance).

[143] Unfair Commercial Practices Directive 2005/29/EC.

[144] Unfair Contract Terms Directive 1993/13/EEC.

[145] See on this topic, the dissertation of the author (in Dutch): V. Colaert, *De rechtsverhouding financiële dienstverlener – belegger* (Brugge: Die Keure 2011) 672p; and a summarizing article in French: V. Colaert, 'Les règles de conduite MiFID, le droit de la consommation et le droit civil: une relation complexe' (2012) Revue Pratique des Sociétés 271-310; I. MacNeil, 'Rethinking conduct regulation' (2015) JIBFL 413-420.

[146] Original Directive 1985/611/EEC; today consolidated UCITS V Directive 2009/65/EU.

[147] Those conditions include (i) strict conditions for the management and depositary function of the fund; (ii) conditions relating to the types of assets and liquidity of assets invested in; (iii) conditions relating to the risk-spreading of the assets invested in; (iv) conditions relating to redemption settlement periods; (v) provision of information and transparency to unitholders (prospectus, KIID, annual and semi-annual financial reports, at least every fortnight publication of net asset value…).

not abide by the UCITS rules. This instance of product regulation therefore functions as a quality label, with UCITS funds being sold all over the world as reliable retail products.[148]

B. Recent trends

31. Overview. The post-crisis era has witnessed a shift in the longstanding tradition to not regulate investment products. New European rules have introduced three different kinds of product regulation: (i) new product quality requirements; (ii) regulation of the product design; and recently even (iii) outright product banning.

1. Product quality requirements

32. Product quality requirements. A first type of product regulation provide that certain products can only be brought in circulation if they fulfill certain quality requirements.

33. From UCITS to AIFMD. The subsequent UCITS Directives have refined the product quality requirements for funds that want to benefit from the UCITS passport and the reputation that goes with it.[149] In the aftermath of the crisis, the EU legislator took new measures. Hedge funds were blamed for having worsened the crisis. The European legislator therefore decided to intervene in the regulatory framework of the entire fund industry. As the range of investment funds "other than UCITS funds" is very diverse – including hedge funds, private equity funds and real estate funds – the approach taken was to regulate the managers of those funds rather than the funds themselves.[150] The Alternative Investment Funds Managers Directive 2011/61/EU ("AIFMD") indeed requires *all* managers of investment funds managed and/or marketed in the EU to fulfill certain quality requirements (except for the already regulated UCITS funds and their managers). In addition, for specific types of funds further product quality measures have been introduced or will be introduced shortly.[151] For these funds, the AIFMD or the UCITS Directive apply on top of those specific measures.

34. No unregulated funds. It means that all funds managed and/or marketed to investors in the EU, are now in principle subject to product quality requirements, either by virtue of the UCITS regime or the AIFMD regime (except for some exceptions and *de minimis* thresholds in the AIFMD).[152] It also means that unregulated funds are banned from being marketed in the EU.

2. Product design

35. Product design. A second, new product regulation technique interferes in the product design phase. Such product design rules do not set exact minimum standards which should be fulfilled, but impose a process to be followed in the product design phase in order to improve the quality of the product.

36. UK. Already in July 2006, in the context of its "Treating Customers Fairly" project, the FSA developed as second outcome of the project: "Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted

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[148] Therefore the UCITS Directive is the first Directive to appear in Mandarin on the European Commission's website. See 'UCITS Funds now speak Mandarin' *FT* 15 February 2015.

[149] See for an overview: N. Moloney, *EU Securities and Financial Markets Regulation* (OUP 2014) at 200.

[150] Art. 1 and 2 (1) and (2) AIFMD 2011/61/EU, see also: recitals 6, 10, 92 and 94; see for an in depth discussion: D. Zetsche, *The Alternative Investment Fund Managers Directive* (Kluwer Law international 2015).

[151] See Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds (ELTIFs) OJ L 123, 19 May 2015; and the proposal for a Regulation of the European Parliament and of the Council on Money Market Funds (COM/2013/0615 final), on which the Council and the European Parliament reached an agreement in November 2016.

[152] Art. 2 (3) and 3 AIFMD 2011/61/EU.

accordingly."[153] One year later the FSA came up with a specific report on product design.[154] After that the FSA has focused on specific guidance for retail product development and governance in relation of structured products, leading to finalized guidance in 2012.[155]

37. France. In 2010 the French Autorité des Marchés Financiers has issued a position paper in respect of the commercialization of complex products, which, amongst other things, requires product distributors – investment services providers or investment advisors – to create a target group of clients to whom they intend to market the product, in light of an analysis of its advantages and disadvantages.[156]

38. The Netherlands. The Netherlands have introduced a similar product governance obligation in their financial regulation in 2013.[157]

39. ESMA. In March 2014 ESMA, by virtue of its powers to enhance customer protection and foster investor protection, issued an opinion on good practices regarding product governance arrangements for structured retail products, encouraging supervisors to promote the examples of good practices featuring in the annex to the opinion. Although the focus of the opinion is on structured products sold to retail investors, ESMA explicitly considers that they may also be a relevant reference for other types of financial instruments as well as for sales to professional investors.[158]

40. MiFID II and IDD "product governance". Finally "product governance requirements" have been harmonized at EU level by both MiFID II (for financial instruments) and IDD (for insurance products). Investment firms and insurance undertakings and intermediaries which produce financial instruments or insurance products for sale to clients should ensure that those financial instruments or insurance products are designed to meet the needs of an identified target market of end clients.[159] For financial instruments also a "negative" target market should be defined, i.e. groups of clients who should not be targeted in the sale or distribution of the product.[160]

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[153] FSA, 'Treating customers fairly. Towards fair outcomes forconsumers' (July 2006) https://www.fca.org.uk/publication/archive/fsa-tcf-towards.pdf, at 12, 32 and 49.

[154] FSA, 'Treating Customers Fairly (TCF) in product design' (July 2007) at

[155] FSA, 'Treating Customers Fairly –Structured Investment Products' (October 2009); FSA, 'Finalised guidance - Retail Product Development and Governance –Structured Product Review' (March 2012) https://www.fca.org.uk/publication/finalised-guidance/fg12-09.pdf; FCA, 'Structured Products: Thematic Review of Product Development and Governance' (March 2015) https://www.fca.org.uk/publication/thematic-reviews/tr15-02.pdf.

[156] AMF, 'La commercialisation des instruments financiers complexes' (Position AMF n° 2010-05) at 5.

[157] Art. 32 Besluit Gedragstoezicht financiële ondernemingen Wft.

[158] ESMA, 'Opinion. Structured Retail Products - Good practices for product governance arrangements' (ESMA/2014/332, March 2016).

[159] Art. 16 (3), 2nd-4th para and 24 (2) MiFID II 2014/65/EU and art. 25 IDD 2016/97/EU. These product design rules also feature conduct of business rules: the investment firm should ensure that the strategy for distribution of the financial instruments is compatible with the identified target market, and that the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the identified target market.

[160] ESMA, 'Draft guideline on MiFID II product governance requirements' (ESMA/2016/1436, 5 October 2016) para 58. With respect to insurance products, it is yet to be decided whether a negative target market should be defined. See EIOPA, 'Public Hearing on the Insurance Distribution Directive (Frankfurt, 23 September 2016), report available at https://eiopa.europa.eu/Pages/Events/Public-Hearing-on-the-Insurance-Distribution-Directive.aspx.

Those product governance rules introduce a kind of "know-your-customer" at group level: as from the product design phase the profile of a target group of clients should be taken into account so that the product can be geared toward that target group.

41. Product design and distribution. It should be noted that these product governance rules are not limited to the product design phase. An intense interaction with the distribution side is necessary. After the product has been designed with a target group in mind, the product distributor should ensure that the product is sold to the right target group of clients. Therefore, product manufacturers are expected to provide adequate information to distributors, to regularly review investment products offered or marketed, and to check that products function as intended.[161] Product distributors on the other hand have to ensure that products and services are compatible with the characteristics, objectives and needs of the target market and have to take into account how the products and services relate to other applicable MiFID conduct of business and organizational requirements.[162] Product design and product distribution are therefore closely intertwined.

42. Effect. Distributors should in principle only sell products to the target market. Selling products outside the target group is not absolutely forbidden, but should not happen "on a regular basis" and the reason for the deviation should be clearly documented.[163] selling products in the "negative target market" should be a "rare occurrence" and the justification for the deviation should be accordingly significant.[164] This means that in fact a whole range of products will not be available any more to certain categories of clients, depending on how the "target market" and the "negative target market" for products are defined. The product governance rules have very clear consumer protection goals and will undoubtedly decrease the risk of miss-selling. Conceptually, however, although product governance rules are usually not framed as a product ban, they do have very similar effects. Product governance rules can indeed be considered as a (well-regulated) self-regulatory tool, which, if conscientiously applied, can render regulatory intervention in the form of product banning, unnecessary.

3. Product banning

43. Background. Even more intrusive is outright product banning, i.e. the prohibition to sell certain products to (retail) investors. For a very long while, the idea to prohibit a category of insufficiently informed investors to acquire certain products, was considered extremely p)aternalistic and an unacceptable infringement of the freedom of choice.

One of the first academics to consider the possibility of product banning, was Choi, who claimed that "*Some investors may lack either the rationality or the capacity to investigate and accurately value protections provided at even the aggregate level. … In addition, in recognition of the precarious informational state in which unsophisticated investors find themselves, the proposal goes one step further and would limit unsophisticated investors to investments in*

[161] ESMA, Final Report - ESMA's Technical Advice to the Commission on MiFID II and MiFIR (19 December 2014 ESMA/2014/1569) 59-61.

[162] According to ESMA, this means for instance that if the product is difficult to explain, the sales process should be adapted; that the product governance arrangements should be periodically reviewed; that sales information should be provided to manufacturers to assist them in meeting post-sale responsibilities; and that copies of promotional material should be supplied to support product reviews by manufacturers. (Ibid).

[163] ESMA, 'Consultation Paper. Draft guideline on MiFID II product governance requirements' (ESMA/2016/1436, 5 October 2016) para 32 and 61.

[164] ESMA, 'Consultation Paper. Draft guideline on MiFID II product governance requirements' (ESMA/2016/1436, 5 October 2016) para 42 and 62. ESMA indicates that such justification is generally expected to be more substantiated than a justification for a sale outside the positive target market.

only passive index mutual funds …".[165] At the time, Choi was heavily critiqued for these ideas.[166] The recent crisis has however led to increasingly wide support for product banning as an investor protection technique, albeit on a smaller scale than Choi proposed.

44. Member State measures. At Member State level there has been some experimenting with this type of investor protection, especially with respect to (certain) complex products. In order to circumvent the question whether outright banning is compatible with the maximum harmonization goal of MiFID I, some Member States have come up with creative solutions.

45. France – product warnings. France was one of the first Member States to take action against the marketing of "complex structured financial instruments with a possible risk of mis-selling". It however did not go so far as prohibiting the sale of these products. Instead, any advertisement or marketing material with respect to highly complex products with a high risk of miss-selling, should mention the following warning: "The prospectus of this complex security has been endorsed by [name of regulator], however the AMF deems this product to be too complex to be sold to retail investors and has therefore not examined its marketing material".[167] Although this is no outright product ban, the measure is clearly designed to discourage the sale of complex products to a retail public.

46. France – marketing ban. Moreover, France is considering to introduce a prohibition on electronic marketing of highly speculative and risky products, including binary bets, CFDs and foreign exchange products, to retail customers.[168]

47. Belgium – Voluntary moratorium. The Belgian Financial Services and Markets Authority (FSMA) has followed suit by introducing a "Voluntary moratorium on the distribution of particularly complex structured products" on 20 June 2011.[169] The aim of this moratorium is to induce the financial sector to refrain from offering retail clients structured products that are considered particularly complex. Distributors that sign up to the voluntary moratorium commit to abstain from offering to retail clients structured products that do not meet the criteria that have been established in the moratorium. Those distributors should further provide the FSMA with their marketing documentation on complex products before offering such products to the public so that compliance with the moratorium can be verified.[170] Participating distributors are put on a list kept by the FSMA. Adherence to the Moratorium is voluntary in principle, but the FSMA has promoted it a lot and virtually all players on the Belgian market have signed. Once signed, the moratorium is contractually binding.[171]

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[165] S. Choi, 'Regulating Investors, Not Issuers: Market Based Proposal' (2000) California Law Review at 300–01

[166] E.g. R. Prentice, 'Whither Securities Regulation? Some behavioral observations regarding proposals for its future' (2002) *Duke Law Journal.*

[167] AMF Position No 2010-05, Marketing of complex financial instruments (15 October 2010), updated as from 12 January 2017.

[168] AMF, 'Consultation publique relative à l'interdiction de la publicité portant sur certains contrats financiers hautement spéculatifs et risqués' (1 August 2016), http://www.amf-france.org/Publications/Consultations-publiques.

[169] FSMA, 'Moratorium on the distribution of particularly complex structured products' (FSMA/2011_02, 20 June 2011) http://www.fsma.be/en/Article/nipic/nipic.aspx.

[170] The moratorium also includes a number of conduct of business rules. Distributors should for instance ensure that the information included in the marketing materials is sufficient and comprehensible for the group to whom such materials are addressed and disclose the value of the derivative component and of the savings component to the FSMA prior to offering a product to the public.

[171] I have classified the moratorium as a product ban, since it has as an effect that products with more than three layers of complexity are no longer marketed and sold to retail investor. The moratorium could, however, also be classified as a product quality requirement, as it also regulates the level of complexity of complex products.

48. Belgium – product ban. While the Moratorium remained in place, the Belgian legislator went one step further in 2014. The Belgian Twin Peaks II Act gave the FSMA regulatory powers to subject the distribution of financial products to certain conditions.[172] The FSMA has used this competence not only for the Royal Decree on product labeling (see nr 12), but also to adopt a regulation on product bans. It is, since 30 May 2014, forbidden in Belgium to sell a number of risky or complex products to retail clients:[173] "life settlements";[174] products derived from virtual currency;[175] and financial products derived from unusual products, such as art, antiques, old wine or whisky.[176] As from 18 August 20016 a second FSMA product banning regulation entered into force, prohibiting the commercialization towards consumers via electronic trading platforms of binary options, derivatives with a duration of less than one hour and derivatives with a leverage effect (such as CFD's and rolling spot forex contracts).[177] The latter regulation also prohibits a number of aggressive or inappropriate commercialization techniques, such as cold calling via external call centers, fictitious presents or bonuses) when commercializing OTC-derivatives towards consumers.

49. UK – product ban. Also in the UK the Financial Conduct Authority (FCA) has introduced an outright product ban in August 2014, by prohibiting to sell contingent convertible instruments (Coco's) to retail clients.[178] On 6 December 2016 the FCA opened a consultation possible measures in respect of the commercialization of CFDs, (binary) spread betting and rolling spot foreign exchange products towards retail customers. Except for binary bets, the proposed measures do not include outright banning of those products, but rather enhanced conduct of business rules, such as higher margin requirements for retail clients investing in CFD's and a ban on financial promotions offering bonuses and other incentives to open accounts or trade.[179]

50. Germany. The German "Bundesanstalt für Finanzdienstleistungsaufsicht" (BaFIN) initially did not go as far as a product ban for CoCo's, but explicitly considered those products in general as "not suitable for active distribution to retail clients".[180] In August 2015 Germany

[172] Art. 30bis of the Act of 2 August 2002 on Financial Supervision.

[173] Royal Decree of 24 April 2014 endorsing the FSMA regulation on the prohibition of commercialization of certain financial products to retail clients, *Belgian Official Gazette* 20 May 2014, 40095.

[174] A life settlement is a product which attributes to the buyer the claim of the insured against his insurer should the insured person decease. It is therefore a product which speculates on the death of the insured person. The FSMA considers these products as very complex, risky and utterly prone to fraud. See art. 2, 1° of the FSMA regulation on the prohibition of commercialization and point II.1° of the explanatory memorandum.

[175] In the explanatory memorandum the FSMA identifies the following risks: hacking of a trading platform or digital wallet leading to loss of virtual money; operational risk of these systems, which are not formally supervised by financial supervisors; exchange rate risk; absence of legal guarantee on exchangeability or acceptance as payment instrument. See art. 2, 2° of the FSMA regulation on the prohibition of commercialization and point II.2° of the explanatory memorandum.

[176] The FSMA considers that the value of these products is difficult to determine through their packaging into more saleable products, such as bonds or investment insurance products. Art. 2, 3° and 4° of the FSMA regulation on the prohibition of commercialization and point II.3° and 4° of the explanatory memorandum.

[177] Royal Decree of 21 July 2016 endorsing the FSMA regulation framing the commercialization of certain financial derivatives towards consumers, *Belgian Official Gazette* 8 August 2016, 47883.

[178] FCA, Temporary product intervention rules - Restrictions in relation to the retail distribution of contingent convertible instruments (August 2014).

[179] FCA, 'Enhancing conduct of business rules for firms providing contract for difference products to retail clients' (CP16/40, December 2016) https://www.fca.org.uk/publication/consultation/cp16-40.pdf.

[180] See Elke König (President of BaFin), Rede zur Jahrespressekonferenz der BaFin 2014, (Frankfurt am main, 20 May 2014), https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Reden/re_140520_jahrespressekonferenz_p.html?nn=7845970; Axel Tophoven, Thorsten Becker, Chan-Jae Yoo, 'CoCo bonds: Risks for retail investors' (BaFin

has however attributed a new power to BaFIN, to restrict or even prohibit financial instruments, structured deposits or financial activities and practices if these present a significant investor protection concern or a threat to the stability or integrity of the financial system or financial markets.[181] The new provision has explicitly been based on the wording of the MiFIR product intervention provisions (next paragraph) and has been claimed as serving to bridge the time period until the MiFIR provisions come into force.[182] In September 2016 BaFIN ended a public consultation on a draft order to prohibit the marketing, distribution and sale of certificates linked to creditworthiness risks ("credit-linked notes" (Bonitätsanleihen)) to retail clients. BaFIN indeed intended to introduce such a measure,[183] but finally decided not to do so as the sector voluntary committed to a number of "Principles for the issuance of credit-linked notes for distribution to retail clients in Germany", including a commitment not to issue credit-linked notes with a denomination of less than 10.000 EUR and not to distribute to retail investors credit-linked notes with complex structures.[184]

51. Other Member States. Also other Member States are considering to introduce product intervention measures, such as the Netherlands which is considering to introduce a ban on advertising for certain risky products.[185]

52. EU – outright banning. Also at the EU level the idea that even the enhanced PRIIPs product information and detailed conduct of business rules when selling complex products, are insufficient measures to protect retail investors against the risks of investing in complex products has gradually gained ground. After the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) had been using their consumer protection competences to issue warnings against certain products,[186] the MiFIR[187] and the PRIIPs Regulation have provided the legal basis allowing to take further steps. They attribute "product intervention powers" to ESMA, EBA and EIOPA (the European Insurance and Occupational Pension Schemes Authority) in their respective fields of competence, i.e. ESMA with respect to financial instruments; EBA with respect to structured deposits and EIOPA with

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Expert Article, 15 October 2014) http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2014/fa_bj_1410_coco-bonds.html).

[181] Section 4b of the German Securities Trading Act (Wertpapierhandelsgezetz, WpHG), introduced by the German Retail Investor Protection Act (Kleinanlegerschutzgesetz, 3 July 2015).

[182] Thorsten Becker, Chan-Jae Yoo, 'Product intervention: New tasks for securities supervision' (Sept 2015) BaFIN Journal 10-12 (available in English on www.bafin.de).

[183] Hearing: General Administrative Act pursuant to section 4b (1) of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG) regarding credit-linked notes, https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Aufsichtsrecht/Verfuegung/vf_160728_allgvfg_bonitaetsanleihen_en.html.

[184] https://die-dk.de/media/files/German_principles_for_the_issuance_of_credit_linked_notes.pdf. Six month after the date of application (16 December 2016) of the principles BaFin will examine whether this voluntary commitment is indeed effective. See: https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2016/pm_161216_bonitaetsanleihen_branche.html.

[185] Draft Decree to adapt the Decree on Conduct Supervision for Financial undertakings in respect of the introduction of rules dealing with advertisements targeted to consumers in the Netherlands with respect of risky financial products (20 February 2017), https://www.internetconsultatie.nl/reclame_risicovolle_financiele_producten.

[186] E.g. EBA and ESMA, Investor warning – Contracts for Difference (CFDs) (28February 2013); EBA, Warning to consumers on virtual currencies (1 EBA/WRG/2013/01 12 December 2013); ESMA, Warning about CFDs, binary options and other speculative products (ESMA/2016/1166, 25 July 2016). In the latter document ESMA already explicitly refers to the new powers attributed under MiFID II and MiFIR and the further steps it may take at that time (p. 3).

[187] Markets in Financial Instruments Regulation (EU) N° 600/2014.

respect to insurance based investment products. This means that, on certain conditions,[188] they can temporarily prohibit or restrict in the EU (a) the marketing, distribution or sale of certain such products or (b) a type of financial activity or practice.[189] Each of the European Supervisory Authorities has developed – very similar – "criteria and factors to be taken into account in applying product intervention powers",[190] which have been transposed into two Commission Regulations.[191]

The MiFIR and the PRIIPs Regulation further explicitly allow Member States' competent authorities, upon certain conditions, to (continue to) prohibit or restrict the same in or from their Member State.[192] ESMA, EBA or EIOPA, respectively, shall in such circumstances perform a facilitation and coordination role. They shall ensure that action taken by a competent authority is justified and proportionate and that where appropriate a consistent approach is taken by competent authorities.[193] The typical "comply or explain" approach applies in this matter: the competent European Supervisory Authority can give an opinion on whether it deems action by the competent authority appropriate; if the competent authority does not comply with such opinion, it should immediately publish on its website a notice fully explaining its reasons.[194]

As the MiFIR and PRIIPs Regulation have not yet entered into force, the ESA's have not yet taken concrete action. It remains to be seen how they will attempt to coordinate the various measures already taken today by national authorities.

IV. Conclusion

53. Recent years have witnessed a tidal wave of new EU financial regulation in general and investor protection legislation in particular. This contribution has attempted to bring some order in the multitude of rules, by sorting them into three main building blocks: information, service quality requirements (conduct of business rules) and product regulation. By doing so, the following trends and challenges have emerged.

54. Information. The idea of informing investors to enable them to take rational investment decisions remains an important aspect, not to say the foundation of EU investor protection

[188] (a) the proposed action addresses a significant investor protection concern or a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union; (b) regulatory requirements under Union law that are applicable to the relevant insurance-based investment product or activity do not address the threat; (c) a competent authority or competent authorities have not taken action to address the threat or the actions that have been taken do not adequately address the threat.

[189] Art. 40-41 of the MiFIR; Art. 16 of the PRIIPs Regulation.

[190] ESMA, 'Final Report - ESMA's Technical Advice to the Commission on MiFID II and MiFIR' (ESMA/2104/1569, 19 December 2014) 187-196; EBA, 'Technical advice on possible delegated acts on criteria and factors for intervention powers concerning structured deposits under Articles 41 and 42 of Regulation(EU) No 600/2014 (MiFIR)' (EBA Op/2014/13, 11 December 2014); EIOPA, 'Technical Advice on criteria and factors to be taken into account in applying product intervention powers' (EIOPA-15/564 29 June 2015).

[191] Commission Delegated Regulation supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions (C(2016) 4369 final, 14 July 2016); Commission Delegated Regulation supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council with regard to product intervention (C(2016) 2860 final, 18 May 2016).

[192] Art. 42 MiFIR; art. 17 PRIIPs Regulation.

[193] Art. 43 MiFIR; art. 18 PRIIPs Regulation.

[194] Ibid.

legislation.[195] The information paradigm has however been fine-tuned and adapted to economic and certain behavioural insights. Legislators in the EU have come to understand that for investors to absorb and compare information, there should not be too much of it (information overload), it should be well-structured in conformity with a standardized format, and it should be attractive and accompanied by visual aids where possible. A clear trend with respect to information as a tool of investor protection is indeed a focus on presentation and a tendency towards short, standardized key information documents. At the same time the legislator has understood that the "caveat emptor" principle, underpinned and reinforced by the information paradigm, has reached its limits in the financial services sector. Behavioural biases and flawed investor decisions cannot or only partially be solved by simpler, shorter and more standardized information. Information requirements are therefore increasingly complemented with two other building blocks of investor protection: service quality rules (conduct of business) and product regulation.[196]

55. Services quality (conduct of business) rules. The goal of conduct of business rules is to improve the quality of the services provided by a financial institution to its clients. The services provider will usually act as an information intermediary, ensuring that product information actually reaches the client. In some instances he is also given the positive task to draw a customer profile and assist the client, e.g. by warning him or her against a transaction in a financial instrument which he does not sufficiently understand or by advising against a product which does not comply with his or her investment objectives or financial situation. Specific rules on conflicts of interest, inducements and best execution aim to ensure that the services provider always acts in the best interest of the client.

Confidence that these conduct of business rules are the right way forward in the field of investor protection is high. Not only has MiFID II further "enhanced" the conduct of business rules, by creating new rules on the one hand and by detailing existing rules on the other hand. Also the scope of application of the conduct of business technique has been broadened, applying them to structured deposits and – via the Insurance Distribution Directive – to insurance products.

56. Product regulation. An actual revolution can be discerned in the third building block of investor protection, product regulation, which was virtually inexistent before the 2007 crisis. The crisis has opened minds to a previously unthinkable investor protection method, further curtailing the traditional purely liberal approach towards retail investor protection, which left the final decision whether or not to invest to the investor himself.

We have distinguished three types of product regulation. With the UCITS Directive, the oldest type are product quality requirements. With the introduction of the Alternative Investment Fund Managers Directive (AIFMD) the European legislator aimed to ensure that also all other investment funds are subject to product quality requirements (in this case conditions for the

[195] See also recently: European Commission, 'Green Paper on retail financial services: Better products, more choice and greater opportunities for consumers and businesses' (10 December 2015, COM(2015)630 final) at 2: "Building confidence and trust will be crucial to the expansion of the single Market in this area. To achieve these objectives, services and products must be comprehensible: in other words, information on their function, their price and how they compare to other products should be available in a way that consumers can understand". See also at 18.

[196] Compare to Moloney, *How to Protect Investors* (n1) at 213: "MiFID is also strongly associated with the eclipsing of disclosure and with a sharper focus on the supply-side reforms associated with support of the trusting investor".

management of the fund). The *indirect effect* of this approach is that funds not managed by a UCITS or AIFMD licensed manager, are banned from being marketed in the EU.

Two other legislative initiatives *directly* impede or prohibit access by a certain category of investors to products deemed inappropriate for them. Product governance rules require product manufacturers and distributors to define the target market for each financial product. Product manufacturers should develop new products with that target group of investors in mind; distributers should not actively market those products outside the target market. Access to those products for investors outside the target market is thus effectively impeded (although not totally excluded). National legislators as well as the EU legislator have finally also taken the ultimate step by introducing (the possibility for) outright product bans, prohibiting the marketing, distribution or sale of certain products to retail investors. Those product bans can be considered the backstop of EU investor protection regulation, to be used when all other investor protection measures fail to protect the financial consumer against inappropriate or harmful products.

57. A cross-sectoral approach to investor protection. An overarching tendency in each of the building blocks is a more cross-sectoral approach to investor protection, levelling the playing field between banking, investment and insurance products and services. The PRIIPs regulation introduces a Key Information Document with the same "look and feel"[197] for a range of complex banking, investment and insurance products. The MiFID II conduct of business rules apply to structured deposits (banking products), next to the traditional financial instruments (investment products). Although insurance based investment products are regulated by a separate directive, the Insurance Distribution Directive (IDD), the IDD conduct of business rules have to a large extent been aligned to the MiFID II conduct of business rules. The scope of application of the product governance rules follows the same logic: MiFID II product governance rules apply to structured deposits and financial instruments, whereas IDD provides very similar rules for insurance-based investment products. With respect to product banning, finally, MiFID II and the PRIIPs Regulation provide identical competences for EBA, ESMA and EIOPA in the three sectors.

We believe this trend towards a more horizontal approach, although not perfect,[198] is laudable. A challenge for EU financial regulation is to decide how far this trend should go. It is indeed important to define the scope of application of rules sufficiently wide in order to avoid gaps, overlaps and unsubstantiated differences. With respect to product information it might be a good idea include other comparable products (such as simple deposits) and to remove unsubstantiated differences between standardized information sheets in an even wider domain (e.g. non-life insurance[199], consumer credit[200], mortgage credit[201]). Even if

[197] Explanatory Memorandum to the Proposal COM(2012) 352 for a Regulation of the European Parliament and of the Council on key information documents for investment products, at 8-9.

[198] See for a critical appraisal of the scope of application of the PRIIPs Regulation: Colaert, 'Regulation of PRIIPs' (note 50) at 208-210; for a critical appraisal of the unsubstantiated differences between the MIFID II and IDD conduct of business rules: Colaert, 'MiFID II in relation to other investor protection regulation' (note 116), para 21.34

[199] Art. 20 (8) and (9) IDD requires EIOPA to develop draft implementing technical standards regarding a standardised presentation format of the insurance product information document specifying presentation details.

[200] Standard European Consumer Credit Information (art. 5 and Annex II of Consumer Credit Directive 2008/48/EC).

[201] European Standardised Information Sheet (ESIS) (art. 14 (2) and Annex II of Mortgage Credit Directive 2014/17/EU).

differentiation will remain necessary in view of the particularities of those products, using a highly similar format would increase the familiarity of consumers with the concept of product information documents in general. With respect to conduct of business rules one might even consider to come up with one horizontal set of general consumer protection principles for the financial sector as a whole, possibly as part of EU consumer protection legislation (e.g. the Unfair Commercial Practices Directive).

58. Interaction between different players in the chain. Obviously the three building blocks of investor protection should not be considered in isolation. The necessity of cooperation between product manufacturer and services provider increases, as has in particular been shown in respect of costs information and product governance requirements. Such cooperation however raises many legal questions and practical difficulties (see nrs. 24 and 41). One of the main challenges of EU investor protection legislation today is to closely knit the three levels of investor protection together into a strong and well-functioning investor protection scheme.