

ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS

Response from the Association of British Insurers

Introduction

The ABI welcomes the opportunity to respond to ESMA's discussion paper on UCITS Exchange Traded Funds (UCITS ETFs) and Structured UCITS.

The ABI is the voice of the UK's insurance, investment and long-term savings industry. It has over 300 members, which together account for around 90% of premiums in the UK domestic market. The UK insurance industry is the third largest in the world and the largest in Europe. Employing more than 300,000 people in the UK alone, it is an important contributor to the UK economy and manages investments of £1.5 trillion, over 20% of the UK's total net worth.

The ABI has not responded to all of the detailed questions set out in the discussion paper. We have submitted responses to questions where we wish to highlight a particular issue.

Summary

The ABI does not support proposals to categorise UCITS ETFs and Structured UCITS as complex. There is little evidence provided to support such proposals and, though UK insurers do not provide these instruments, we are not aware of any detriment arising from the sale of these instruments to retail consumers.

The re-categorisation of financial instruments as 'complex' should not be carried out on an ad-hoc basis. Instead, the ABI believes that ESMA and the European Commission need to focus on developing a definition of 'complex' which can be consistently applied across all financial instruments.

The UCIT's 'brand' was developed by the EU and the prescriptive rules on governance and management (including those recently introduced by UCITS IV) make these an appropriate non-complex retail investment vehicle. There is no market evidence of failure of these products or of mass detriment to the investors who buy them. Whilst they may employ relatively 'complex' structures this does not equate to risk and such structures can deliver less risky outcomes for investors.

The ABI has developed an alternative definition of 'complex' which moves away from the approach adopted in MiFID (focusing on the underlying assets and/or packaging associated with a financial instrument) to one which focuses on the potential outcomes of the investment including the variability, volatility and risks to the outcome for the consumer.

A revision of the definition of 'complex' is the best and most consistent way to ensure that retail investors do not end up investing in inappropriate instruments. To further protect consumers who may be considering investing into complex financial instruments, we believe that changes are required to the existing appropriateness test so that it enhances consumer's understanding of the instrument they are looking to purchase.

Do you agree that ESMA should explore possible common approaches to the issue of marketing of synthetic ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors? In not, please give reasons.

We are not aware of consumer detriment associated with the sale of UCITS ETFs and Structured UCITS in the UK and are concerned that little evidence of detriment has been provided within the discussion paper to justify the proposals. Regulatory intervention should only be considered where there is strong evidence of consumer detriment. On this basis, we do not support ESMA's proposals that UCITS ETFs and Structured UCITS be re-categorised as complex.

However, we do urge ESMA to develop a framework for identifying high-risk investments and managing the risk of consumer detriment.

Do you think that structured UCITS and other UCITS which employ complex portfolio management techniques should be considered as complex? Which criteria could be used to determine which UCITS should be considered as complex?

We do not support the ad hoc re-categorisation of certain financial instruments as 'complex'. If concerns exist about the potential impact of some financial instruments on consumers, we believe it is necessary to revise the definition of 'complex' within MiFID so that it can be applied consistently across all instruments.

Complex portfolio management techniques do not necessarily produce greater risk for the consumer. The use of derivatives, for example, can actually help to reduce the risk and volatility of outcomes for consumers. Focusing on the financial proposition a consumer purchases, rather than on the underlying management techniques identified in the consultation paper, will ensure an approach that can be applied consistently across all instruments from direct investment in equities and funds through to packaged investment products.

When making an investment, the most important information for consumers is what they can expect to get from their investment and the factors which can influence this outcome. For direct investment into equities, the outcome will depend on the performance of the share purchased. For other instruments, UCITS funds, for example, the variability, volatility and risk to the consumer is determined by a number of factors including:

- the assets held
- the level of diversification
- the objectives of the investment
- protections or guarantees which may apply

These factors work in combination to determine the risk and return to the consumer's investment. By focusing on the potential economic outcomes for the investor, rather than on the portfolio management techniques (or assets held, as is currently the case in MiFID) it is possible to capture all variables which impact on the overall performance of the financial instrument.

Furthermore, we believe our proposal to base the definition of complex on the variability, volatility and risk to consumer outcomes is consistent with wider work being undertaken by ESMA including the development of the Synthetic Risk Reward Indicator (SRRI) through the Key Investor Information Document (KIID).

A detailed proposal for a new definition of complex can be found in Annex A.

Do you have any specific suggestions on the measures that should be introduced to avoid inappropriate UCITS being bought by retail investors, such as potential limitations on distribution or issuing of warnings?

The ABI believes that limitations on the distribution of financial instruments should only be used in prescribed and extreme circumstances, such as in response to specific significant market failures. There may be some merit in providing early warnings to consumers about financial instruments which represent a higher risk and a source of potential consumer detriment. It is important to ensure good communication channels with the industry before issuing warnings of this sort, and take care that messaging is evidence-based and properly qualified. It may be more appropriate for national regulators to issue any such warning rather than ESMA.

However, in the main, we feel that a different approach to identifying complex investments is the best and most consistent way to manage the risk of retail consumers investing in inappropriate instruments. This would ensure that instruments which represent greatest risk to consumer outcomes cannot be sold on execution-only basis and would require providers to undertake an appropriateness test before selling them to retail investors.

To further ensure that consumers do not end up investing in inappropriate financial instruments, we believe that changes are required to the existing appropriateness test. We are concerned that the existing test is failing consumers for a number of reasons including:

- It misleads consumers into thinking the suitability of an investment has been assessed;
- It requires investment providers to collect information about a consumer's knowledge and experience, even though this information is not a good guide to assessing whether an investment is appropriate; and
- It restricts the ability of consumers to access financial instruments through a distribution service which meets their needs and budget.

The appropriateness test should be amended, so that it enhances consumer understanding of the complex financial instrument they are looking to purchase by providing clear information that enables consumers to assess whether the product is right for their financial needs. An amended appropriateness test should require investment providers selling

complex financial instruments to outline the individual circumstances where it would be inappropriate to purchase the instrument without advice.

Full proposals to enhance the appropriateness test including an illustrative example can be found in Annex B.

Annex A

Revised definition of complex and non-complex financial instrument

Background

In the Market in Financial Instruments Directive (MiFID) public consultation, European Commission outlined proposals to clarify the distinction between 'complex' and 'non-complex' financial instruments. These proposals have been taken forward by the European Securities and Markets Authority (ESMA) who are consulting on guidelines to re-categorise certain instruments (UCITS Exchange Traded Funds and Structured UCITS) as complex

The existing definition of complex (set out in MiFID) focuses on both the underlying assets held and the risk associated with the financial instrument (for example, the use of derivatives). The proposals made in the ESMA consultation advance on this definition by including complex investment strategies. Rather than concentrating on these features, the ABI believes it would be more consistent to develop a definition of complex which focuses solely on the potential outcomes of the investment (including the variability, volatility and risks to the outcome for the consumer).

ABI's proposed definition of complex and non-complex financial instruments

When developing a definition of complex and non-complex financial instruments, we believe it is misleading to focus on the composition of the investment, the underlying assets held or the investment strategy adopted. Instead, we suggest it is more appropriate to consider the financial proposition the consumer purchases. This ensures a consistent approach is adopted across all financial instruments, including direct investment in equities, funds or through a packaged investment product.

When making an investment, the most important information for consumers is what they can expect to get from their investment and the factors which can influence this outcome. For direct investment in equities, the outcome will depend on the performance of the shares purchased. For other investments, for example, UCITS funds or packaged products, the variability, volatility and risk to the consumer outcome is determined by a number of factors which includes the:

- assets held;
- proportion of the portfolio invested in different assets types;
- the level of diversification;
- objectives of the investment; and
- protections or guarantees which may apply.

These factors work in combination to determine the risk and return to the consumer's investment. By focusing on the potential economic outcomes for the investor it is possible to this capture the variables which impact on the overall performance of the financial instrument.

How would the ABI's proposed definition apply to derivatives?

The current MiFID rules suggest that where a derivative forms part of a non-UCITS financial instrument, this instrument should be categorised as a complex investment. Financial instruments which include some use of derivatives are a good example of why it would be more appropriate to consider the potential outcomes for consumers rather than the underlying assets held.¹

Direct investment in derivatives can expose investors to significant risks. Indeed, the risks associated with a derivative mean that an investor could potentially lose money in excess of their original investment. It would therefore seem sensible to categorise direct investment in derivatives as complex. However, the use of derivatives in other investments can actually help reduce risk and volatility of outcomes for consumers.

In packaged investment products, for example, derivatives are typically used as part of a wider investment strategy. They form part of a balanced portfolio of investments by experienced investment managers to achieve a number of potential goals:

- significantly reduce the risk to a consumer's investment;
- provide a mechanism for the investment to increase in value where the majority of the exposure is in low risk funds; or
- where the product seeks to provide consumers with consistent returns across all market conditions.

Whether a particular investment is categorised as complex should not depend on whether the fund makes use of derivatives, but how the portfolio of assets held and which make up the product effect the outcomes and risk associated with investment.

Next steps

We believe our proposal to base the definition of a complex or non-complex financial instrument on the variability, volatility and risk of consumer outcomes is consistent with wider work being undertaken by the Commission. This includes the development of the Synthetic Risk Reward Indicator (SRRI) through the Key Investor Information Document (KIID) and UCITS IV requirements for firms to provide prominent statements in marketing and communications where an investment has a high level of volatility.

To take forward our proposal, we believe ESMA and the Commission should explore the different risks associated with different financial instruments. For example, some financial instruments and products, which may use derivatives as part of the investment strategy, offer guarantees so the consumer cannot lose their original investment. These should be considered as non-complex investments. In contrast, the risk associated with some financial instruments, such as direct investment in derivatives, exposes consumers to risk where they

¹ A derivative is a financial contract whose value is derived from the value of an underlying asset. This asset could be bonds, currencies, short-term interest rates, individual shares, stock market indices or even different commodities. The derivative allows investors to take an exposure to an underlying asset without requiring ownership of the asset. They allow investors to make profits on upward or downward movements in the value of the underlying asset.

could lose a sum in excess of their original investment and would therefore be considered complex.

We also suggest that ESMA and the Commission move away from the current 'complex/non-complex' distinction as it is more accurate to focus on risk to consumer outcomes. For example, the composition, management and underlying assets of a guaranteed packaged product could be considered complex. However, this may be packaged so it is simple for the consumer to understand, with low levels of risk to the investment. Consumers should be able to access these low-risk, straightforward investments without the need for a 'suitability' or 'appropriateness' test.

Both the ABI and our members would be keen to work closely with ESMA and the Commission to develop this work and would welcome an opportunity to discuss our proposals in further detail.

Annex B

Proposals to enhance the appropriateness test

Background

The European Commission has consulted on a number of changes to the Markets in Financial Instruments Directive (MiFID). A major concern for the ABI and our members is the possible requirement to expand the financial instruments for which an 'appropriateness test' is required.

The ABI supports the need to ensure there are appropriate standards of consumer protection and our members are committed to providing consumers with clear information about the financial investments they offer. However, we do not believe the appropriateness test, in its current form, will help deliver these objectives. We suggest the test should be reviewed and amended because it:

- can mislead consumers to think the 'suitability' of an investment has been assessed;
- can restrict consumers' ability to access financial products through a distribution service which meets their needs and budget;
- prevents experienced investors from simply accessing their chosen investment and taking responsibility for their purchase;
- creates additional costs and administrative burden for providers which can potentially exclude some consumers from the market; and
- requires investment providers to collect information about a consumer's knowledge and experience to assess whether an investment is appropriate, even though this information is not a good guide when assessing whether an investment is appropriate for a consumer.

It is important to clarify that we are not suggesting changes should be made to the 'suitability test', which helps ensure consumers who choose to access financial advice receive good outcomes. We are proposing changes to the appropriateness test only. The two tests differ in the following ways:

- The suitability test applies when a firm recommends a financial investment to their client. The suitability test requires firms to obtain the necessary information about their client's financial position and objectives to ensure the recommend services or investments are suitable.
- The appropriateness test applies to non-advised sales of complex financial instruments. The appropriateness test requires firms to assess their client's knowledge and experience, relevant to the product being purchased, to check whether the product is appropriate. This process does not undertake an assessment of a client's needs and demands nor does it assess whether the product is suitable for the client.

ABI's proposed changes to the appropriateness test

The ABI proposes the appropriateness test should be amended so that it enhances consumer understanding of the financial instrument they are looking to purchase by providing clear information that enables consumers to assess whether the product is right for their financial needs.

We believe an amended appropriateness test should require investment providers selling complex financial instruments to outline the individual circumstances where it would be inappropriate to purchase the financial instrument without advice. This appropriateness statement would also:

- explain why it is important for the consumer to consider the appropriateness statement;
- remind the client they will not benefit from the protection afforded to consumers who had taken financial advice; and
- refer the client to investment documentation, including the product terms and conditions, for further information about the investment.²

We have illustrated how an appropriateness statement could look below.

To further protect consumers, we believe investment providers should ensure the financial instrument and appropriateness statement are designed to meet the needs of consumers in the target market. This would be backed up with effective internal governance processes that ensure investment providers are meeting this requirement.

We believe the ABI's proposed changes to the appropriateness test can be incorporated into the MiFID Directive by rewording *Section 2 – Article 19 point 5* of the Directive to read:

Member States shall ensure that investment firms, when providing investment services other than those referred to in paragraph 4, to retail clients, provide an appropriate statement for the investment in a clear, standardised format. This should outline to the client or potential client, as identified as the target market, circumstances which would make it inappropriate to purchase the investment. This should also highlight the availability of financial advice services if the client requires further help.

If the information provided by the appropriateness statement indicates to the client that it is not appropriate to purchase the investment, prominent warnings shall be given to the client or potential client that the investment would not be appropriate for them. This warning may be provided in a standardised format and highlight the additional help available through financial advice services.

In cases where the client or potential client ignores the appropriateness statement referred to under the first subparagraph, the investment firm shall warn the client or potential client that the service or product envisaged may not be appropriate for him. This warning may be provided in a standardised format.

² For UCITS investments, the client could be referred to the Key Investor Information Document (KIID) which is being developed by the Commission.

ILLUSTRATIVE EXAMPLE OF THE ABI'S PROPOSED APPROPRIATENESS STATEMENT FOR AN INVESTMENT LINKED FINANCIAL INSTRUMENT

COMPANY
LOGO

To help you assess whether the [name of investment] is right for your circumstances, we have developed a short appropriateness statement. We recommend you complete this self-assessment before deciding whether to purchase the investment.

If, after completing this self-assessment, you are unsure whether the [name of investment] is right for you, we recommend that you seek help from your financial adviser.

The investment will not be right for you if you answer yes to any of the below statements:

Financial circumstances		Why is this important?
Y/N	I am looking for a guaranteed rate of return	The [name of investment] does not provide a guaranteed rate of return. As the performance depends on the movement in the value of a series of stocks and shares, the value of your investment can go up or down.
Y/N	I am not willing to accept any loss to my money invested even though this <u>may</u> mean I get a higher return.	The performance of the [name of investment] depends on the movement in the value of a series of stock and shares. The value of your investment is not guaranteed and may fall. This may mean you get back less than you paid in.
Y/N	I am likely to need access to my money within five years	As the value of your investment can go up or down, it is not usually appropriate for people who are likely to need the access the money within five years.
Y/N	I have no other savings I can access in case of an emergency	Although you will be able to access your money at any time, the investment is designed for people looking to save for five years or more.

And so on.....

Further information on the [name of investment] can be found in our [name of investment documentation]. This will be available in your investment pack or [website address].

This self-assessment does not constitute financial advice and [name of firm] has not assessed whether the [name of investment] is suitable for your individual circumstances.

If you require further help to assess whether the [name of investment] is suitable for you, please speak to your financial adviser.