

Opening address by Steven Maijoor, Chair of ESMA, at the Paris EUROPLACE Financial Forum, 6 July 2011: The European Fund Industry Paradigm: Combining Long Term Investment Horizons and Risk Profiles

Ladies and Gentlemen,

I am very pleased to have the opportunity to speak at your conference today. I would like to commend Paris EUROPLACE for organising this event and offering a program with distinguished speakers and panellists covering such a broad range of key regulatory issues.

Throughout the process that led to my selection as the first Chair of ESMA, I made it clear that one of my top priorities for ESMA's work is protection of retail investors. I would like to set out today why I think this is such a key issue, both for the EU fund industry and more broadly, and give some detail on the areas in which this priority can be put into action.

It cannot yet be said that the damage to investor confidence caused by the crisis has been repaired, but the restoration process is under way. And the evolving consolidated European supervisory and regulatory approach towards investor protection is one way to restore investor confidence. The financial crisis has led many investors and potential investors to lose faith in financial services providers and in many of the products they offer. Indeed, according to the European Commission's autumn 2010 Consumer Markets Scoreboard, the market for investments, pensions and securities is one of the three markets most likely to be failing consumers across the EU. This is a situation that I believe needs to be addressed if consumers are to have proper access to the investment products they need with a view to their long-term savings. Let me be clear – a lot more work needs to be done before we arrive at a situation where there is a clear focus on the investor's needs.

The debate on the so-called 'retailisation' of complex structured investment products has intensified over the last year, and regulators around the world are becoming increasingly active in this area.

In its advice to the Commission on its MiFID review in July last year, CESR (ESMA's predecessor) specifically pointed out that the Commission could explore strengthening the right of retail (and professional) clients who trade OTC derivatives and other complex or tailor-made products (such as structured products) to request information in the form of a risk/gain profile in different market conditions prior to the transaction, as well as independent quarterly valuations of these complex products.

That same CESR advice also suggested that the MiFID compliance controls around new products could be strengthened by requiring MiFID investment firms to have specific organisational requirements relating to the launch of new products and services.

CESR also addressed this issue in its technical advice to the Commission on MiFID conduct of business rules – including proposing amendments to clarify and to deliver a more graduated risk-based approach to the distinction between complex and non-complex products in the context of MiFID's appropriateness test, including the suggestion that there was a case for considering treating structured UCITS and UCITS



that employ complex portfolio management techniques as complex financial instruments for the purposes of the appropriateness test.

We are glad to see that CESR's input on these areas has helped to shape the Commission's MiFID consultation. The Commission's consultation paper specifically addressed each of these three proposals through its own proposals (all set out in Chapter 7 of its CP) for 'informing clients on complex products' (see 7.2.3); 'organisational requirements for the launch of products, operations and services' (see 7.3.3), including stress testing products and services; and 'execution-only services' (see 7.2.1).

Also, CESR's report on trends, risks and vulnerabilities in financial markets (issued in July last year) highlighted the increasing trend towards packaging of relatively complex alternative investment strategies by means of more traditional retail-oriented investment vehicles. In this context, ESMA is carrying out work to assess the expected and observed returns of complex products sold to retail investors. Looking at retailisation from a financial stability perspective, meanwhile, ESMA is closely involved in work being led by the European Systemic Risk Board.

Looking across the Atlantic, only last month the US SEC issued a specific communication on structured notes with principal protection, warning of such aspects as potential credit risk associated with such products and possible misunderstandings around the impact of derivatives on the return.

Individual authorities within Europe have also been taking active steps in this area recently. To take one example, the UK FSA published a discussion paper earlier this year setting out its proposed new regulatory approach, based on intervention by the regulator at a much earlier stage of the product design process. This would represent a significant shift away from focusing on point-of-sale requirements and appropriate disclosure.

One product that has been attracting particular attention recently is exchange-traded funds (ETFs). In April both the Financial Stability Board (FSB) and the Bank for International Settlements (BIS) published papers on ETFs. These papers focus on the move away from traditional ETFs into synthetic and more exotic structures and their impact on investor protection and financial stability. As I announced publicly a few weeks ago, ESMA is in the process of finalising its policy orientations on ETFs and certain other types of UCITS and we will be publishing them for consultation later this month.

I think it is important to recognise that there are a number of other initiatives, at different stages of development, that will help us address some of the problems I highlighted earlier. The first one that I'd like to mention is the Key Investor Information Document for UCITS, the KIID. CESR did a huge amount of work over several years to develop technical advice to the Commission, then Level 3 guidelines, on the format and content of the KIID. The new disclosure document has become a reality for investors as of the first of July, the transposition date for the UCITS IV Directive. I am confident that the KIID will represent a major improvement in the quality of information provided to potential investors in UCITS, focusing on such key elements as risk/reward disclosures and charges.

Mention of the KIID brings me to a related topic that is relevant to today's debate, namely the Packaged Retail Investment Products initiative (PRIPs). As you will be aware, the objective of PRIPs is to achieve a consistent approach to pre-contractual product disclosures and selling practices across the main types of retail investment product. For the disclosure part, the KIID for UCITS has been identified by the European Commission as the appropriate benchmark. This is clearly something we welcome as we feel it recognises the quality of the work we have been doing to develop the KIID.

As far as selling practices are concerned, the relevant provisions of MiFID – such as the duty to treat investors fairly and avoid conflicts of interest – have been taken as a point of reference. We look forward to seeing the more detailed proposals from the Commission on the different aspects of PRIPs later this year, and of course we are ready and willing to provide any assistance necessary. Given the cross-sectoral nature of this work, we will look to co-operate closely with our counterparts at EBA and EIOPA wherever appropriate.



The final piece of work that I would like to talk about is the development of the new ESAs' powers under Article 9 of the regulations establishing the authorities. Article 9 sets out ESMA's tasks relating to consumer protection and financial activities, including establishing a new 'Committee on financial innovation' and working with the other two ESAs under the Joint Committee which should contribute to more consistency across sectoral financial products and services. The tasks also involve an increased need for research (including data collection from national competent authorities and analysis of consumer trends, for example), and an increased focus on financial innovation (by monitoring new/existing financial activities).

In keeping with ESMA's overall 'enhancing customer protection' objective, ESMA may also consider issuing 'investor alerts' or 'consumer warnings' (relating to specific product types or selling practices or activities) under Article 9(3), in addition to any banning that ESMA may put in place in terms of its new Article 9 remit.

It is reassuring to note that in the context of stricter regulatory scrutiny of complex products, the Commission is also proposing (through its MiFID review) to introduce powers relating to 'bans on specific activities, products or practices'.

If we look at the situation as it stands now and the various initiatives under way at EU and national level, I think we can identify some overall themes. One is that improved disclosures and selling practices are absolutely essential in helping consumers make the right decisions for their particular circumstances. Another is that there has to be a change in the attitude of the finance industry towards its customers. There needs to be a shift away from seeing investors as potential sources of profit to putting a proper focus on matching the risk profiles of potential investments to the customer's needs. This applies just as much, if not more, at the product design stage as at the moment where a consumer discusses potential investments with an adviser. Furthermore, where industry behaviours in relation to selling practices and product intervention fall short of what investors – especially retail investors – ought to be able to expect, it is likely that ESMA's solution (where competent authorities do not take measures, or the measures taken do not sufficiently address the threat to investor protection) will be to warn investors about certain products, or even go so far as to ban certain products and/or financial activities. All of this should not divert attention away from the need to improve levels of financial education among consumers more generally, which will help put them in a position to make better decisions on their own.

You may be wondering about the potential costs of the different initiatives I've mentioned and the impact they might have on firms' profits. Most of the initiatives are based on improving compliance with current requirements so should only result in limited incremental costs for firms. And we should bear in mind that it's now within ESMA's power to ban certain products or activities. While banning a product may curb profits, perhaps the more appropriate question the industry should ask itself is whether it should be selling certain complex products to retail customers in the first place. I would also highlight that for an industry to be viable and profitable, it needs to have the confidence of its customers. If consumers continue to experience poor outcomes in their dealings with the financial services sector, they are less likely to turn to that industry in the future. It is therefore in everyone's interests for outcomes to be improved and confidence to be restored.

I have spoken today about some of the challenges I believe the financial services industry faces as it deals with improving investor protection in the post-crisis landscape. I have also summarised several initiatives that we believe are addressing certain of the most pressing issues as far as investor protection is concerned. My main message for you today, however, is that we are only at the beginning of rebuilding investor confidence in the financial services industry and that no effort should be spared in achieving that goal.

Thank you for your attention.