

## **‘What problems do consumers face when seeking financial advice?’**

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Ladies and gentlemen,

Good afternoon. I am very pleased to have been invited here today, and to have the opportunity to speak about and discuss investor protection issues with you. Investor protection is a core ESMA objective. It is ingrained in its establishing Regulation and informs many of our actions.

There is a history in European securities markets of developing common approaches to the equal treatment and protection of investors. This has generally been done by setting standards for the harmonisation of conduct of business rules across the European Union’s Member States. As a result of lessons learned from the early experiences of this financial crisis, for example, CESR was vested with the responsibility of helping to ensure, and improve, the consistent implementation and application of the MiFID investor protection provisions. As you will be aware, the Markets in Financial Instruments Directive (MiFID) was introduced in 2007 in order to harmonise the investor protection framework across the European Union, and is one of the most important milestones in this area.

However, with the creation of ESMA and the other two European Supervisory Authorities (ESAs) in 2011, this work has the potential to be greatly enhanced. All three ESAs have been tasked with an explicit investor protection responsibility. As you well know, the Regulation establishing ESMA specifically states that, as one of its tasks, ESMA ‘shall foster investor protection’ (Article 8). It further describes certain ESMA ‘tasks related to consumer protection and financial activities’ (in Article 9).

Ingraining investor protection responsibility into the EU regulatory framework more strongly in this way is a significant step forward: it moves investor protection into another realm. What is significant about our new powers, and this explicit responsibility, is that we can now change the way we do things. In particular, we can take a much more pro-active, and effective, approach towards investor protection. I’ll describe what I mean by this shortly, but first let me highlight a few of the investor protection issues that we are trying to address. I should note that I will talk about investors also as ‘financial consumers’. Using this broader term underlines that financial consumers should always receive the same protection when buying a product with an investment element, irrespective whether it is an insurance product, a banking product or securities market product.

### ***What problems do financial consumers face when seeking advice?***

Supervisory experience and market research demonstrate that financial consumers can be faced with the following problems. Of course, investor protection issues aren’t limited to these examples only, but I highlight these examples for our purposes today.



- **Lack of quality of financial advice.** Unsuitable investment advice is provided, for example, because the extent and the nature of information gathered about a client's profile – on financial needs and background - varies between intermediaries. Limitations in gathering this essential client information, and, importantly, analysing it in order to get an understanding about the client, is cause for concern.
- **Unsuitable products.** One driver for this is exposure to the high investment risks inherent in some products, for example, coupled with the inherent complexity, opacity or insufficient information of some products. This can be compounded by a lack of compliance with selling practices requirements when selling complex products.
- **Inducements.** Other important factors leading to unsuitable products being recommended are: (i) the conflicts of interest arising because of inducements provided to advisers; (ii) biases such as the limited range of products from which an adviser can select for recommendation; and (iii) also perhaps as a result of prejudicial remuneration practices.

These problems cannot be solved with more transparency. This holds true even when the information is 'fair, clear and not misleading'. We know now that too much information can confuse clients, especially unsophisticated retail clients, and can lead to them making bad choices or wrong decisions. I must admit here that I am trained as an economist and always have been taught that the combination of rational decision making by consumers, full transparency, and competition among suppliers solve many problems in markets. However, experience has now sufficiently shown that this market mechanism does not work effectively in financial markets and that regulation and supervision is needed to get the right outcomes and to protect financial consumers.

### ***What is ESMA doing about this for retail investors together with national regulators?***

ESMA has, does, and will act on all these aspects.

We are currently consulting on guidelines (Article 16 of the ESMA Regulation) to clarify certain aspects of the MiFID suitability and compliance function requirements in order to improve, amongst other things, due diligence on gathering information on the client's background when providing suitable investment advice. These guidelines aim to foster convergence of practices in this area across the Union. We are also seeking to develop a complimentary set of guidelines on remuneration practices. These will be more focused on remuneration practices of investment firms from an investor protection point of view – relating, as they do, to the MiFID conduct of business risks and conflicts of interest rules when providing investment services.

Working with national regulators on foreign exchange issues, we noted certain concerns and emerging trends. So, in December 2011, ESMA took pro-active action to address these issues: we published our first investor protection warning (Article 9 of the ESMA Regulation). ESMA warned retail investors against dealing with unauthorised firms and individuals offering foreign exchange investments, and alerted retail investors to the main risks involved in forex trading. Given the size of the so-called 'forex' market, and increasing retail investor participation in it, ESMA viewed this 'pro-action' as an essential part of its 'enhancing investor protection' objective. We won't stop here: working with the national competent authorities, ESMA is alive to issuing further investor warnings as and when the need arises.

I've just mentioned 'working with the national competent authorities'. ESMA's new duties also include the requirement to establish a 'Committee on financial innovation'. ESMA's new Financial Innovation Stand-



ing Committee (FISC), through participation of the national competent authorities, aims to assist ESMA in fulfilling its investor protection responsibilities. It will do this mainly by facilitating a co-ordinated approach to the regulatory and supervisory treatment of new or innovative financial activities. Through regular data collection on consumer trends, FISC will seek to identify potential risks to investor protection, and to financial stability, in the financial innovation area; and then to produce a risk mitigation strategy.

In this regard, the powers set out in the MiFID proposals for both ESMA and national regulators to intervene to protect investors from inappropriate products or services by banning products is a major leap forward. These proposals have been developed in the context of the new world we live in: rapid innovation, the ever increasing complexity of financial markets and products, as well as increasing retail investor participation in these financial markets. All these developments necessitate the need for higher levels of investor protection. The key challenge for ESMA here is, of course, the co-ordination of any action taken by national competent authorities. ESMA will need to take account of the fact that some national initiatives may be appropriate to address specific national risks - but other market failures will raise common concerns across the EU. This means that ESMA will have to manage the inevitable differences and co-ordinate accordingly – as we should avoid national action creating fragmentation in the market and possibly creating consumer confusion.

Another issue here is the extent and practicability of these intervention powers. Whilst we appreciate the need for building in safeguards and limiting the scope for intervention, we need also to ensure that there is the real possibility for ESMA to take swift action, where necessary, in this important area of product intervention.

MiFID already sets a high level framework for an investment firm's organisational requirements, but we were pleased to see the European Commission's consultation ideas on this. The Commission suggested further specifying the relevance of organisational controls at the stage when firms design their general policies and decide which products are to be offered to clients. This has translated, in part, into the new MiFID concept of 'management body'. We will be considering how, in turn, we should translate that into some form of guidance for firms on internal controls around product development.

### ***ESMA is also active on the investor information and product transparency front***

As you probably know, the UCITS Directive regulates European mutual funds and allows funds to be marketed to retail investors on a cross-border basis. The revised UCITS IV Directive and its implementing legislation entered into force on 1 July 2011. One of the key reforms of the UCITS IV package is the introduction of the Key Investor Information Document (KIID) to replace the simplified prospectus. The KIID, which is limited to two sides of A4, or 3 sides for structured UCITS, is already helping retail investors make informed investment decisions by setting out, in a user-friendly and readable way, key information on such elements as the investment policy, risk and reward, charges and past performance. ESMA's predecessor, CESR, made a significant contribution to the development of the detailed content and format of the KIID through its technical advice provided to the Commission.

ESMA is also currently working to tighten a number of the requirements that apply to Exchange Traded Funds (ETFs) that fall under the UCITS Directive through the development of guidelines. While ETFs can offer certain benefits like low costs of diversification of investor investments, there are certain risks that need to be addressed. Therefore, some of ESMA's key proposals include an obligation on ETFs to include an identifier in their name, additional requirements on disclosure and a general strengthening of the standards on collateral received in the context of securities lending activities. We also set out options on how best to allow investors that buy ETFs in the secondary market to be able to dispose of their units. We



expect that these guidelines, some of which are also relevant to other UCITS that are not listed, will be finalised in the summer this year.

### ***Efforts to improve consistency across products***

While ESMA's work to strengthen the regulatory framework for ETFs is important, it's equally important to bear in mind that many other exchange-traded products (ETPs) compete with ETFs. These other products, such as notes and certificates, may not offer the same regulatory protections as are afforded under the UCITS framework. The Packaged Retail Investment Products (PRIPs) initiative, including the proposed inclusion within MiFID's scope of structured deposits, represents a real step forward with respect to improved disclosures and consistent selling practices for competing products. ESMA fully supports this initiative, especially where it delivers consistent investor protection regardless of the legal form of products. However, we think there is a case for addressing also the manufacture and management of such products.

### ***Conclusions***

I'd like to make three final comments in conclusion.

Firstly, we acknowledge that developing a closer cooperation with investor and financial consumer organisations will be key in delivering our investor protection obligations. We are seeking to improve investor organisation representation on our relevant Consultative Working Groups, where possible. And, as you already know, of the 30 members of ESMA's own Securities and Market Stakeholder Group, there are approximately 10 representatives that are not from the financial industry. These 10 represent, variously, consumers and retail investors, employees of financial markets participants, and academia. The Chair of this Group himself comes from an organisation representing retail investors. This is a big increase in investor representation when compared to the rather more limited investor representation of yesteryear. All this is a good start. But there is surely more we can do here in terms of engaging even more fully with financial consumers and hearing their voice more loudly.

Secondly, the development of sectoral legislation, such as MiFID 2 and MiFIR, will undoubtedly strengthen our role in the investor protection field. The 2011 revised MiFID proposals clearly seek to strengthen investor protection through an even stronger framework for the provision of investment services to retail clients. It is, however, important to note here that we should not only focus on changing the regulation. We should also ensure that MiFID 1 is properly implemented, effectively supervised and enforced in a similar way across the EU - even while all the MiFID 2/MiFIR negotiations and debates continue.

And by no means lastly: while ESMA has continued what CESR started by way of addressing the issues that financial consumers face when they seek financial advice, what is much more important today, and going forward, is that ESMA has begun not only to take much stronger action in this regard, but also to change our culture so that investor protection concerns are key in our minds when taking action - effective action - to protect financial consumers.

Thank you.