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COMMISSION STAFF WORKING DOCUMENT
EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

Proposal for a
REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
on
Key information documents for investment products

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COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

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**Proposal for a
REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
on
Key information documents for investment products**

1. INTRODUCTION

The focus of this impact assessment is product disclosures in the retail investment market.

This market is dominated by so-called 'packaged retail investment products' (PRIPs) – financial product manufacturers intercede between retail investors and financial markets, building products to satisfy specific investment goals, usually with the intention of being sold to retail investors either directly or through intermediaries. Common examples of PRIPs include investment funds such as UCITS, retail structured products and unit-linked insurance contracts; there are others.

To protect investors, sectoral measures that require defined information to be provided to retail investors have developed. This information is used by investors before they make investment decisions, though it sometimes has not been designed solely for this purpose. The existing measures have proven in some cases ineffective – requirements vary according to the legal form of products, not their economic nature or risks, making comparisons between products and comprehension of product features harder. In practice product disclosures are typically focused more on covering off legal risks for the provider rather than providing effective and balanced communication to clients.

In its April 2009 Communication on PRIPs, the Commission concluded that such failings could be traced (amongst other things) to the lack of a common framework and approach to such information at the European level, which could only be addressed by legislative change at the European level. (The Communication noted two areas of further work: rules applying to sales, and rules on product disclosures. This impact assessment focuses on the latter only).

The importance of transparency and comparability of information about products for ordinary investors has been underlined by the financial crisis. Retail investors have lost money with investments that carried risks that were not transparent or understood by those investors. There has, perhaps rightly, been a collapse in investor confidence: a recent survey of consumers across the EU showed they trust the financial services less than all other industry sectors.

Improving transparency is vital to rebuild confidence on a sound basis. The EU has already taken innovative steps through the development of the UCITS 'key investor information' (KII) regime. While disclosures for UCITS have now been modernised; those for the other packaged investment products have not. The task now is to address options for these other products.

2. WHAT IS THE PROBLEM?

Retail investors are not always provided with information they can understand and easily compare. This impact assessment identifies three key 'problem drivers' and aims to tackle the second and the third:

2.1.1. Driver 1: Proliferation of product types aimed at same investment needs

There is a potentially bewildering variety of investment products being targeted at retail customers, combining different legal forms often with similar underlying investment propositions. Many factors can contribute to this proliferation. Yet in general terms all of

these products seek to address a relatively simple investor need: capital accumulation (in other words, taking on risk so as to have the potential for beating the risk-free rate of return).

2.1.2. Driver 2: Patchwork of regulation

European and national regulation on product disclosures already applies to most products. However, Union law has developed on a largely sectoral basis, at different speeds and with different outcomes in mind. Such a regulatory patchwork can increase administrative costs and potentially encourage regulatory arbitrage, incentivising choices of product structures to take advantage of less onerous requirements.

This legal patchwork poses two additional threats, separate from those related purely to investor protection: first, the existing internal market in UCITS is subject to direct competition from products that are less strictly regulated in regards product disclosures – or not regulated at all. Second, the current differences in disclosure requirements are likely to be perceived both by investors and by industry as a fragmenting factor along national borders, which do not help any future positive development towards market integration. Current action at the national level for non-UCITS PRIIPs is necessarily uncoordinated, and could lead to increased differences in approach across Member States and sectors without coordination at the European level.

2.1.3. Driver 3: Failures to effectively mitigate asymmetries of information between retail customer and the industry

The financial services are difficult to understand even for professional market participants, in part due to their intrinsic complexity. For retail investors, low levels of financial literacy and capability undoubtedly compound these issues. In addition, for many retail customers there are few opportunities to learn from experience in retail investment markets: customers typically do not engage repeatedly in investment activities, but do so only in relation to certain specific and widely-spaced life events (inheriting money, or investing towards a specific future liability or goal, such as buying a house, retirement or family planning).

Existing investor protection standards are however ineffective and inconsistent, and a proliferation in new products and market innovation have also led to products being offered in forms that were not envisaged during the development of the existing disclosure requirements. The impact assessment outlines in detail evidence showing the undoubted difficulties retail customers have **comprehending** and **comparing** investment products on the basis of current disclosures. It also sets out problems related to the **timely provision of information** so that retail customers actually receive it in the first place.

2.2. Scale of the problem and consequences of not taking action

These drivers lead to investor detriment through mis-sales, to an unlevel playing field between industry sectors, and to the erection of barriers to the further development of the internal market.

- For consumers, a recent study concluded that around 60% of sales in a mystery shopping exercise across all EU markets might be deemed 'unsuitable'. While a number of factors contribute to sales that are not suitable, the scale of this problem of 'mis-selling' clearly requires action. To get a feel for the scale of impacts in aggregate, even if only 10% of sales in the retail investment market could be considered as 'unsuitable' this still could amount to almost 1 trillion EUR of potentially mis-held products given the size of this

market; even if product disclosure contributed only 1% to such sales, this would still amount to around 10 billion EUR.

- For firms, an unlevel playing field distorts competition. Regulatory arbitrage could encourage the development of products or sectors that are subject to the lowest levels of regulation, also undermining the effectiveness of regulation and potentially reducing price competition and so harming investors through higher costs. Other more direct impacts of failings in regulation are also important. Mis-sales can also have a strong impact on firms, raising levels of compensation claims and complaints and internal costs related to managing these, and damaging brand identities.
- In keeping with the Commission's conclusions for the impact assessment that accompanied the 2009 Communication on PRIPs, the impact assessment concludes that without action at the European level to address inconsistencies and gaps in European product disclosure rules, an opportunity to react to these problems would be missed, contributing to continued investor detriment and market distortions, and undermining the single market.

3. SUBSIDIARITY

Taking action at EU level is necessary because the problems identified have been exacerbated by inconsistencies and gaps in regulatory approach at the EU level. Member States acting alone would not address cross-border regulatory inconsistencies, and could not overcome inconsistencies in EU legislation. In addition, action at the EU level ensures the greatest effectiveness in steps to standardise disclosures and improve their comparability.

4. OBJECTIVES

The initiative seeks to improve the quality of investor decision making and the functioning of EU capital markets, tackling a breakdown in confidence and trust in the retail markets. Concrete operational objectives for developing more consistent and effective regulatory standards flow from the problem analysis: improving the **comprehensibility** and **comparability** of products, **ensuring disclosures are provided** at the right time in sales processes; through all of these **improving regulatory consistency**.

5. OPTIONS

Policy options for improving EU rules on disclosures are developed following extensive consultations and experiences developing improved disclosures for UCITS funds. Options are identified in the context of a possible new instrument with level 1 and level 2 measures; the analysis at this stage is in relation to the level 1 measures setting the overall approach, with level 2 measures to follow at a later stage subject to their own impact assessment. In summary, the key areas and the preferred options that emerge are:

- (1) **Scope of initiative.** The scope of products that might be covered impacts on all operational objectives. Alternative options included no action, a narrow scope of only packaged products, a broad scope covering all possible investment products that might be offered, including those that are not 'packaged'. *The preferred option is focusing on packaged products, as these products raise particular consumer protection challenges*

and make up the vast bulk of the retail investment market, but subjecting this to future review.

- (2) **Degree and nature of standardisation of product disclosures.** Standardisation relates both to the degree of prescription imposed on firms in regards the content and format of disclosures provided to retail customers, and to the degree of consistency in requirements between products and financial sectors. Options included different degrees of prescription and standardisation on clarity of language, length, and comparability. *The impact assessment proposes a form of 'targeted standardisation', with flexibility for addressing different products, but as much standardisation as feasible of key information on risks, costs and performance; details on standardisation and its application to specific types of products determined through level 2 measures.*
- (3) **Responsibilities for preparation.** Stakeholders and consultation respondents have broadly underlined the importance of clarity over who is responsible for preparing and updating disclosures. *The impact assessment analysed the option of not prescribing who prepared the document, but it concluded for a broad rule that product manufacturers are responsible for preparing product disclosures, with some targeted exceptions.*
- (4) **Timely provision.** Ensuring effective provision of product disclosures to retail investors before they decide on their investment is vital. *The impact assessment proposes strict requirements on provision of information, but targeted exceptions may be necessary.*
- (5) **Civil liability and sanctions.** Flanking the outlined options, secondary questions on sanctions and civil liabilities arise. Options include a baseline of no action, following a high-level approach or specifying more detailed rules. *The impact assessment foresees a clarification of the liability, to address concerns that the PRIIPs product disclosures become used as legal rather than communicative documents; it also foresees some further elaboration of the sanctioning tools competent authorities have available.*

6. IMPACTS OF THE PROPOSED APPROACH

The retained options propose the establishment of a **new disclosure regime for packaged investment products, modelled on that recently developed for UCITS, though with some additional tailoring of requirements at level 2 to address variations between different products.**

Benefits

Product information the average investor can actually understand and use for comparisons is a fundamental for empowering consumers, without prejudice of course to the role and responsibilities of intermediaries at the point of sale. In addition, the benefits of standardisation and comparability have been underlined by a recent study by the Commission, which concluded that using these techniques in relation to investment decision-making is likely to lead in practice to changes in investor behaviour that contribute to better decision making. Given the potential scale of mis-selling outlined above, small changes could have a huge impact: even if product disclosure were taken to contribute only 1% to changes, this

could still amount to around a 10 billion EUR reduction in holdings of unsuitable products (or 4 billion EUR, if UCITS, already subject to KII requirements, are subtracted).

Greater consistency in requirements would ensure a level playing field between firms operating in different sectors and reduce barriers to the internal market for those operating cross-border. Tackling investor detriment would also benefit the industry: improving trust and reducing the costs generated by problems when they emerge.

Costs

The impact assessment establishes a **rough** estimate of *one-off costs of EUR 171 million, and on going costs of around EUR 14 million per year*. (Given the nature of the changes foreseen, which relate to requirements on disclosures to third parties, these figures are also a good indication of the administrative burden of changes). Evidence is mixed on whether smaller and larger product manufacturers would bear disproportionate costs, and impacts on employment are expected to be low. Distributors are also likely to be impacted, though this is unlikely to be significant, given the focus of this initiative is on product manufacturers.

Final costs will be dependent on **options selected at level 2**, which necessarily limits the accuracy of any assessment possible at this stage. For this reason, a full impact assessment of Level 2 options will be necessary to establish more accurate estimates of the impacts of the proposals, to underpin proportionate choices. This would also allow for better estimates of differential impacts (e.g. on SMEs, distributors).

Monitoring and evaluation

Given the potential for regulatory arbitrage and continued innovation in the retail investment market, continued monitoring of developments will be vital, including evidence-based assessments of the future scope of the regime. In addition, the impact of measures to improve comparisons, particularly on risks and costs, will need careful monitoring and their effectiveness be subject to further evaluation and fine-tuning.

7. CONCLUSIONS

Product disclosures need to improve. New requirements to address such issues have already been introduced for UCITS: this impact assessment has examined options for making similar improvements for all the packaged investment products currently sold to retail customers.

The core tool identified is to increase standardisation of information to allow for greater comparability, though the heterogeneity of products entails a need for some flexibility. This is termed '**targeted standardisation**' in this impact assessment. The analysis concludes that such an approach offers the best chance to achieve clearer and more comparable product disclosures whilst reflecting the practical realities of complex and varied products.

Of course, consumer protection measures in the retail investment markets must always be understood in a holistic manner: a variety of regulatory tools are important and support one another, including steps to improve financial literacy amongst retail consumers and steps to improve the regulation of distributors and sales processes.

However, if clear and comparable information is not made available, informed decisions cannot be taken. The wider significance for the regulation of retail markets of any continued

failure to enable better, more informed decision-making should not be understated. For this reason, the effort and care needed to develop effective disclosure requirements and the costs and effort needed to implement them are small prices to pay for putting retail investment markets onto a surer footing.