

Response European Investors' Association – 11 October 2016

Mis-selling risks in the EU retail investment market

i) Product offerings

The best start to limit mis-selling is to ensure that the products that are marketed to retail investors are developed in such a way that they are actually suitable, in terms of complexity and risk, for at least a large segment of retail investors.

Structured products, contracts for difference, binary options, spread bettings etc. are all easily accessible to retail investors and sometimes even actively (or: aggressively) promoted. In our view, such products are by definition not suitable for retail investors.

The enforced product governance rules foreseen in MiFID II should ensure such products are not sold to retail investors anymore. However, if the rules prove to be ineffective, European or national regulators should not be reluctant to simply ban the sale of these products to retail investors.

Unfortunately, we note that the appropriateness test, the main tool to protect investors against mis-selling in an execution-only environment, provides little protection against such products, simply because the warnings that it generates are not binding and tend to be ignored. The rules on 'target market' should be implemented very strictly and harmonise regulatory measures to be taken to protect retail investors if the product or service developed are not suitable or in the interest of those investors targeted.

ii) Marketing communications and practices

Marketing communications should also be a major focus of any assessment on mis-selling. The EU has worked hard on ensuring consumers have access to objective and standardized pre-contractual information (e.g. KIID for UCITS), which we very much welcome.

However, many consumers make decisions on the basis of marketing communications instead. These communications often downplay the downsides of certain (investment) products and overemphasize potential returns and are therefore not 'fair, clear and non-misleading'.

We strongly believe the supervision on marketing communications needs to be strengthened. Ex-ante approval on the basis of detailed rules, which is already common in a number of Member States, should become standard regulatory practice in the EU. The detailed rules should be set at EU level. On a national level only higher standards of investor protection should be introduced.

Also, marketing practices need be supervised more closely. Instances where cold calling is used to lure naive investors into buying complex investment products should be brought to a halt. The same goes for ads stating a gift or a small capital to start "trading" for free.

iii) Investment services

In order to give suitable advice, an investment firm needs to obtain sufficient information on the personal needs and characteristics of the client (i.e. financial situation, objectives, risk appetite, and knowledge and expertise). Unfortunately, despite MiFID, this is not the case at the moment.

Especially risk appetite is not assessed adequately. This means clients are advised products that do not suit them in terms of the volatility and the potential loss acceptable to them.

Even if the investment firm obtains all information required, mis-selling can still occur if the investment firm does not have the client's interests at heart. The majority of advisers and portfolio managers in Europe are linked to a major bank and receive payments linked to the sale of particular products.

This provides an incentive to put commercial interests above those of the client. We therefore continue to call for a full ban on inducements. In the UK and the Netherlands this has led a rise in the sale of simpler and safer investment products (i.e. index trackers instead of active funds).

iv) Automation

Investment services become increasingly automated. While we welcome the increased accessibility of investment services that such innovations entail (due to lower costs), there are also some risks.

Firstly, the underlying assumptions of the algorithms on which the automated services are based could be flawed. This means an unsuitable advice (or portfolio) is generated on a potentially massive scale.

The second risk relates to the lack of human interaction. If fully automated, the investment firm cannot ask for clarifications in relation to the answers that the client has given to the online questionnaire. Also, the firm cannot answer questions of the client on why the given advice (or portfolio) is suitable.

In order to mitigate these risks, we believe firms that provided automated investment services should be obliged to assign a control team, consisting of experts on algorithms as well as certified investment advisers, that closely monitors the suitability of the advice (or portfolio) that is generated.

Also, firms should provide clients with the opportunity to talk (in exchange for a reasonable charge) to a certified investment adviser to gain clarifications on the advice that was given to them.

v) Supervisory convergence

We would like to close with some general comments on financial supervisory framework in the EU. We strongly believe it is time to enter a new stage.

For the single market to work, retail investors need to be sufficiently protected against mis-selling regardless of the national competent authority (NCA) that the investment firm is subject to. To this end, supervisory practices in the EU need to converge.

It should be avoided that a weak spot allows for the proliferation of mis-selling practices through the whole EU (e.g. binary option providers operating from Cyprus). A more active role for ESMA in the field of investor protection is therefore warranted.

Also, cooperation among NCAs needs to be strengthened. A number of financial regulators suffer from insufficient human resources and expertise to cope with their obligations under EU law. Other NCAs should help these NCAs (e.g. through posting of expert teams).