

CONSUMER PROTECTION IN FINANCIAL SERVICES – TOWARDS GREATER TRANSPARENCY WITH A KEY INFORMATION DOCUMENT FOR PACKAGED RETAIL INVESTMENT PRODUCTS

MAJA KOZŁOWSKA*

INTRODUCTION

As the European Commission emphasizes, important problems have been identified in the EU retail investment market¹. Product information about investments is often considered as weak and difficult to use, conflicts of interest bedevil the distribution of products, and the regulation of the market is fragmentary and inconsistent. Therefore, retail confidence in the credibility of financial services has collapsed following the financial crisis.

The three legislative proposals published on 3 July 2012 are designed to enhance consumer protection in financial services. The first of the proposals (UCITS V)² is a draft Directive which amends the UCITS IV Directive currently in force, and focuses on strengthening the obligations and responsibilities of depositaries³. The second legislative proposal seeks to recast the Insurance Mediation Directive that regulates access to and the exercise of insurance and reinsurance mediation activities. The third proposal is a draft Regulation on a New Key Information Document for Investment Products; it concerns packaged retail investment products (PRIIPs) and establishes the requirement of the aforementioned key information document (KID)⁴.

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* Dr Maja Kozłowska, PhD Lecturer at the University of Opole, Financial Regulations Analyst, mkozlowska@uni.opole.pl

¹ See Marcin Tyniewicki, 'Rola dyrektywy MiFID w ochronie inwestorów na rynku finansowym Unii Europejskiej' in Eugeniusz Ruśkowski, Iryna Zawerucha (eds), *Public Finance and Financial Law in the Context of Financial Crisis in Central and Eastern Europe* (Białystok-Lwów 2010) 598-608.

² Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) in respect of depositary functions, remuneration policies and sanctions, COM (2012) 350 final.

³ <http://www.nortonrose.com/knowledge/publications/69109/priips-key-information/documents-for-packaged-retail-investment-products>, accessed 10 August 2012.

⁴ Proposal for a Regulation of the European Parliament and the Council on key information documents for investment products, COM (2012) 352 final.

The upcoming and currently discussed regulation on the key information document and its analysis constitute an input for the better understanding of growing tendencies towards consumer protection within the financial services in the EU, especially if we consider there are very few publications on the topic in the Polish literature.

Following the need to develop a more horizontal approach aimed to enhance investor protection standards, the European Commission (EC) issued a Consultation Paper on PRIPs on 26 November 2010⁵, indicating firstly the ‘asymmetries of information’ existing between investors and those producing and selling investments to them, and secondly the manufacturing and distribution of these products leading to principle/agent issues (e.g. those producing and selling investments face conflicts between their own interests and those of their clients). As C. Bernard and P. Boyle emphasize, in most cases the retail investor does not have the expertise to understand the complexities of these contracts and obtains advice from an agent who is remunerated by sales commissions. Moreover, if the producer’s surplus is shared with the sales agent, then there are incentives for the agent to push more complex products⁶. The identified problems were particularly significant for so-called packaged retail investment products (PRIPs), which offer exposure to underlying financial assets, but in packaged forms which modify that exposure compared with direct holdings. A ‘PRIP’ is ‘manufactured’ (constructed) in a way that assets are combined into a single proposition, or some element of financial engineering is introduced⁷.

I. What is a ‘PRIP’?

Among such products are investment funds such as those governed by the Undertakings for Collective Investment in Transferable Securities (UCITS)⁸ directive or other non-harmonized retail investment funds, structured products that may take many legal forms, and unit-linked insurance contracts⁹. The ‘PRIP’ definition given in the proposed regulation comprises all structured products (whether in the form of securities, funds, deposits or insurance policies, and regardless of any degree of capital protection), insurance funds and insurance products having a surrender value which in some way (direct or indirect) is subject to market fluctuation, OTC derivatives and asset-backed securities and convertibles. Excluded

⁵ http://ec.europa.eu/internal_market/consultations/docs/2010/prips/consultation_paper_en.pdf, accessed 10 August 2012.

⁶ Carol Bernard, Phelim Boyle, ‘Structured investment products and the retail investor’, http://www.eu-financial-system.org/fileadmin/content/Dokumente/Events/Prague_2008_11th_conference/Bernard.pdf, 3, accessed 9 March 2013.

⁷ See Adam Zaremba, *Produkty strukturyzowane – inwestycje nowych czasów* (Helion, Warszawa 2009).

⁸ Directive 2009/65/EC of the European Parliament and the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L302/32.

⁹ Bernard, Boyle (n 6) 1, accessed 9 March 2013.

from the definition are ‘vanilla shares’ and bonds (insofar as these do not contain a mechanism other than a direct holding of the asset), ‘pure protection’ insurance products, and simple (non-structured) deposits. Regarding pensions, excluded are occupational pension schemes falling under the scope of Pension Directive (IOPR) or Solvency II, as well as pension products for which a financial contribution from the employer is required by national law and where the employee has no choice as to the pension product provider. Key criteria of the PRIIPs definition are:

- the product is manufactured or packaged or otherwise financially engineered;
- the return of payout is subject to movements in other assets or underliers;
- PRIIPs are generally designed for the mid- to long-term retail market¹⁰.

In the Consultation Paper on legislative steps for Packaged Retail Investment Products, the EC proposed to supplement the definition with an ‘indicative list’ of products falling within the regime that may be supplemented with technical standards and guidance. Since the new investment products are constantly emerging, such a list of products classified as PRIIPs would not be an exhaustive one.

Currently, the pre-contractual product disclosures are regulated by a number of different European Directives, including the Prospectus Directive, the UCITS Directive, the Solvency II Directive, the Insurance Mediation Directive, and the Markets in Financial Instruments Directive (MiFID). Therefore, a separate piece of legislation aimed to regulate pre-contractual disclosures was expected. Taking into consideration existing disclosures that vary according to the legal form a product takes, it was of a high importance to address these issues. It has been highlighted by the financial crisis, when retail investors have lost money with investments that carried risks that were not transparent or properly disclosed. The proposal was issued in the form of a Regulation, which will be further supported by delegated and implementing acts. The EC proposal will be presented to the European Parliament and the Council for their consideration under the co-decision procedure, and once the agreement is reached, detailed work would be done by the Commission, with the input of experts, consumers and stakeholders on the implementing measures. The full proposal is expected to be in place by the end of 2014; however, considering the challenges resulting from the enhanced product disclosure requirements, the financial services providers are closely monitoring the up-coming legislation¹¹.

II. KEY INVESTOR DOCUMENT (KID) ELEMENTS

A Key Investor Document should be a short and plainly-worded document (comprehensible, the use of jargon is avoided, as are technical

¹⁰ See <<http://www.skarbiec.biz/alternatywne/produkty.htm>> accessed 8 September 2012.

¹¹ See Bartłomiej Kurcz, *Dyrektywy Wspólnoty Europejskiej i ich implementacja do prawa krajowego* (Kraków 2004) 99 ff.

terms when everyday words can be used instead), no more than a few pages long that will provide investors with essential information about the features, risks and costs of an investment product¹².

According to art. 10 of the Proposal (COM (2012) final), the investment product manufacturer shall review the information contained in the KID regularly and revise the document where the review indicates that changes need to be made. The definition 'product manufacturer' comprises any natural or legal person who manufactures an investment product (management companies, issuers, credit institutions, investment firms, etc.) and any natural or legal person making changes to the risk and reward profile and the cost structure of an existing investment product (art. 4 (b) of COM (2012) 352 final). The EC shall be empowered to adopt delegated acts, laying down detailed rules for the review of the information contained in the KID.

According to art. 11, where an investment product manufacturer has produced a KID, which does not comply with the requirements of art. 6-8, on which a retail investor has relied when making an investment decision, such a retail investor may claim from the investment product manufacturer damages for any loss caused to that retail investor through the use of the KID¹³. Moreover, when a retail investor demonstrates a loss resulting from the use of the information in the KID, the investment product manufacturer has to prove that the KID has been drawn up in compliance with art. 6-8 of the Regulation. The burden of the proof shall not be altered through an agreement (art. 11 (2-3)).

Provision of the KID is regulated by art. 12, stating that a person selling¹⁴ an investment product to retail investors shall provide them with the key information document in good time before the conclusion of a transaction relating to the investment product. By way of derogation from paragraph 1, a person selling an investment product may provide the retail investor with the key information document immediately after the conclusion of the transaction where:

¹² ECB opinion on a proposal for a regulation of the European Parliament and of the Council on key information documents for investment products (CON/2012/103). The ECB recommends that the proposed regulation explicitly requires the KID to include the following elements: (i) counterparty, operational and liquidity risks affecting the investment product; (ii) sensitivity of the products' performance to effective stress scenarios; and (iii) the leveraged component of the product insofar as this component may multiply the applicable risks. Such additional information components will ensure that the KID does not lead investors to rely excessively on past performance patterns and that it provides a complete and fair outline of the risks related to the investment products.

¹³ Proposal for a regulation of the European Parliament and of the Council on key information documents for packaged retail investment products (PRIIPs) – Presidency compromise, COD (2012) 0168. The compromise text of 27 November 2012 states that the PRIIP manufacturer is liable for an infringement of this Regulation in case of a loss caused through the use of key information document that was misleading, inaccurate or inconsistent with the relevant parts of the contractual documents of the PRIIP. Moreover, a person shall not incur civil liability solely on the basis of the key information document, including any translation thereof, unless it is misleading, inaccurate or inconsistent with the other binding contractual documents.

¹⁴ The Presidency compromise text widens the provision by adding '[...] persons advising on'.

- the retail investor chooses to conclude the transaction using a means of distance communication;
- the provision of the key information document in accordance with paragraph 1 is not possible;
- the person selling the investment product has informed the retail investor of this fact.

The KID shall be provided free of charge to retail investors. According to art. 13(2), the person selling an investment product shall provide the key investor information document to the retail investor in one of the following media: on paper, using a durable medium other than paper, where the conditions laid down in paragraph 4 are met, or by means of a website where the conditions laid down in paragraph 5 are met.

III. COMPLAINTS PROCEDURE AND COOPERATION

Chapter III: Complaints, Redress and Cooperation covers the fundamental requirements for complaints and procedures to be initiated and conducted. Additionally, it addresses the measures to facilitate and coordinate complaints procedures at manufacturer and Member States levels. Under art. 14 the manufacturer of the investment product must establish all the appropriate procedures to ensure a reply in a timely and proper manner to the retail investors who have submitted a complaint in relation to the KID. According to art. 15, where a retail investor initiates a procedure for alternative dispute resolution laid down in national law against an investment product manufacturer or a person selling investment products with regard to a dispute concerning rights and obligations established under this Regulation, the investment product manufacturer or the person selling investment products shall participate in that procedure, provided that following requirements are fulfilled:

- the procedure results in decisions which are not binding;
- the limitation period for bringing the dispute before a court is suspended for the duration of the procedure for alternative dispute resolution;
- the period of prescription of the claim is suspended for the duration of the procedure;
- the procedure is free of charge or at moderate cost, as specified in national legislation;
- electronic means are not the only means by which the parties can gain access to the procedure;
- interim measures are possible in exceptional cases where the urgency of the situation requires.

Member States must notify the Commission of the national entities with the proper authority to deal with the procedures as per paragraph 1 six months after entry into force/application of the Regulation. They must also notify the Commission of any change concerning those entities. Entities as per the first paragraph must cooperate with each other on the resolution of cross-border disputes arising under this Regulation. Article 16 regulates the cooperation between national bodies, expressing the duty of their

cooperation with each other and with all those entities responsible for out-of-court complaints. Authorities are also obliged to provide one another with all the relevant information in order to comply with the Regulation.

A similar document to the KID has been introduced for UCITS – a KIID – Key Investor Information Document. Therefore, the UCITS are exempt from the new KID regulations for a transitional period of five years (art. 24 of the Regulation Proposal). However, the Commission's aim is that all investment products will be accompanied by KIDs, and that the documents for all investment products are as comparable as possible. Despite that the proposal is for a high degree of standardization of KIDs, the goal is not to impose a 'one size fits all' approach – differences between products need to be reflected as well¹⁵. It will be implementing measures that clarify how differences among products can be handled in order to both provide flexibility and ensure that the client gets the most accurate information about investment products.

Product information that the average investor can actually understand and use for comparisons is fundamental for empowering consumers, without, of course, prejudice to the role and responsibilities of intermediaries at the point of sale. As the EC emphasizes, 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 conducting cross-border operations. In the EC's opinion, tackling investor detriment would also benefit the industry by improving trust and reducing costs generated when they emerge. However, consumer protection measures in the retail investment markets must always be understood in a comprehensive manner, and a variety of different, complimentary regulatory tools are essential, including for consumers' financial education and improvement of regulation of distribution and sales processes. Clear and comparable information about investment products is therefore essential for an informed investment decision and constitutes a basic element in the consumer financial protection strategy. Given the potential for regulatory arbitrage and continued information in the retail investment market, as the EC emphasizes, continued monitoring of developments will be vital, including evidence-based assessments of the future scope of the regime. Risks and costs in particular will require careful monitoring, as will further legislative/delegated acts, accompanied by input from market participants.

III. ADMINISTRATIVE SANCTIONS AND MEASURES

Article 18 of Chapter IV of the Administrative Sanctions and Measures states that Member States have until two years after the Regulation enters into force to notify the Commission and the Joint Committee of the European Supervisory Authorities that they have established appropriate rules to implement and police the Regulation. According to art. 19, application of sanctions is foreseen in cases where the

¹⁵See <http://ec.europa.eu/internal_market/consultations/docs/2010/priips/consultation_paper_en.pdf>17, accessed 12 August 2012.

KID is not provided as a standalone document, is misleading, unclear or contains inaccuracies, excludes essential information about the product, and when marketing information contradicts what is contained in the KID. Sanctions also apply if the KID is not provided free of charge or in a good time. Moreover, the competent authorities shall have the power to prohibit or suspend the marketing of the product, issue a public warning, order a new KID is produced or inform retail investors of their rights and where they may be able to complain for compensation. In order to enforce compliance, sanctions and measures imposed on offending companies shall be disclosed to the public unless this would seriously jeopardize the financial market; the identity of those involved would be disclosed unless that would cause disproportionate damage to the individual concerned.

IV. NEXT STEPS

The PRIP Regulation will apply two years from the date of its publication in the Official Journal¹⁶. The Regulation shall be reviewed after four years, taking into account developments in the retail investment sector which may warrant a possible extension of the Regulation's scope to other investment products (art. 25). According to art. 23, power is conferred on the Commission to adopt delegated acts for a period of four years from the Regulation's entry into force. An EP plenary sitting is currently scheduled for 23 October 2013.

V. CONCLUSION: CHALLENGES FOR THE INDUSTRY AND FOR LAWYERS

New enhanced product disclosure requirements will challenge the industry, increasing competition across investment products and forcing manufacturers to ensure the highest accuracy of KIDs' content. Further legislative developments are to be constantly monitored and evaluated, taking into consideration the practical problems resulting from the variety of investment products (risk scale related issues)¹⁷ as well as other operational challenges for the financial industry, i.e. IT systems adjustments and decisions on KIDs production platforms (internal or external)¹⁸. The marketing area will be also impacted, as under art. 9 marketing communications that contain specific information relating to the investment product shall not include any statement that contradicts the information contained in the key information document or diminishes the significance of the key information document. Marketing communications shall indicate

¹⁶ See Marcin Olszak, *Bankowe normy ostrożnościowe* (Temida 2, Białystok 2011) 111-112.

¹⁷ Key Investor Information Documents (KIDs) for packaged retail investment products – Frequently asked questions, MEMO/12/514 of 3 July 2012.

¹⁸ 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, COM (2012) 352, SWD (2012) 187.

that a key information document is available and supply information how to obtain it. As experts on financial products state, 'a new KID is born'. Definitely now is the time for the industry to ensure compliance and face this new challenge, both from the legislative and production point of view. 'Investment products have social as well as financial consequences and if society wants capital to fund productive activity, the first step is to let investors know whether they are making an investment in the economy or a financial bet'¹⁹. The analyzed legislative developments in the area of financial consumer protection are aimed to provide retail investors with the highest possible level of protection within financial services. Legal certainty, appropriate redress procedures and disclosure requirements are indispensable factors in the complex and constantly changing market environment. The upcoming changes in the field of disclosure requirements analyzed in the article will challenge not only market participants, but also lawyers who will have to ensure appropriate application of the regulation within the financial sector, concentrating on the areas where liability related issues may arise.

¹⁹ <<http://www.finance-watch.org/press/press-releases/311-towards-suitable-investment-decisions-prips/>> accessed 10 March 2013.