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A Life Cycle Approach to Investor Protection

Mirzha De Manuel Aramendía and Diego Valiante

Abstract

The market for investment products, including both securities and investment funds, is fraught with difficulties for consumers in terms of the ease of comparing products, trust in suppliers and consumer satisfaction. A comprehensive approach to investor protection, developed around the lifecycle of a financial product, may offer the investor greater protection during an investment's life span. This paper proposes a new approach to investor protection, building on a review of major market failures affecting the origination, distribution and sale of financial products and based on a review of the relevant scientific literature and country experiences. The application of a 'know-your-product' principle at origination, a narrower 'default rule' for best execution and an ex-ante distinction between advice and 'information-only' services are among the options discussed in this paper to enhance the investor protection framework over the lifecycle of a financial product.

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Introduction

The market for investment products, encompassing both securities and investment funds units, is perceived by consumers as fraught with problems in terms of the ease of comparing products, trust in suppliers and consumer satisfaction (European Commission, 2011a). Yet, investor confidence and protection are crucial to promote savings, investment and economic growth, as well as to foster retirement security. This research report considers how investor protection functions in both theory and in practice and evaluates the current regulatory framework. It builds upon a lifecycle approach to investor protection, devised to illustrate the issues at hand in a comprehensive manner and enable the construction of a holistic policy response. The paper is structured in three sections. The first section investigates the reasons that justify public intervention in retail financial markets to protect retail investors, based on a review of the literature. The second section presents the lifecycle approach to investor protection and the basic tools to ensure an adequate level of investor protection at every stage. Section 3 considers these tools in greater detail and puts forward ways to improve the current framework based on empirical evidence. The value added of this research springs from:

i) Its outline of a general framework for policy-making to overcome a partial approach to investor protection that is frequently adopted by policy-makers;
ii) Its evaluation of different reform proposals on the basis of a review of the relevant scientific literature and country experiences; and
iii) Its presentation of novel reform alternatives based on a comprehensive review of market failures in the sale of financial product (e.g. the separation between 'advice' and 'information-only' services).

This paper considers the micro dimension of investor protection, i.e. the protection of the investor during the life-cycle of a financial product, from origination to disinvestment or maturity.

1. Why do we need investor protection?

Investor protection, while in the use of the ownership rights bundled with the holding of the financial instrument (such as voting rights for shares), reduces incentives to concentrate ownership and promotes the development of capital markets (La Porta et al., 1996), ultimately improving resource allocation and so increasing economic growth. At a more micro level, public intervention in financial markets to protect investors is justified by a number of factors that can lead to market failure. First, information asymmetries between originators, distributors and investors due to the nature of financial instruments exacerbate switching costs and conflicts of interest. Second, behavioural biases present among investors affect their ability to process information provided by the more informed party (e.g. distributors). Last but not least, investors' financial capability, and the advice they might receive, shape key investment decisions for the financial security of investors.

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1.1 Asymmetries of information and the role of financial innovation

A number of factors make it difficult for investors to understand the full set of risks involved in investment products, including the nature of the investment process, as compared to saving. Empirical research has revealed that about 40% of individuals in Europe do not understand that their capital is at risk when investing (Chater et al., 2010). Poor numerical skills also reduce the ability of investors to understand even simple pricing and payoff structures. Moreover, clients do not frequently purchase financial services, and it is precisely the rarity of such purchases that impedes the build-up of useful experience.

Due to their superior information, originators (i.e. manufacturers or issuers of financial instruments and products) and distributors have an incentive not only to exploit any existing asymmetries of information, but also to broaden such asymmetries (increasing monitoring costs for the investors). In particular, intermediaries may 'churn' clients' accounts with transactions that are not necessarily in their best interest. This strategic behaviour is commonly called 'moral hazard', fostered by the inability of investors to monitor intermediaries due to the high costs. There is evidence, for instance, that greater availability of packaged financial products is linked to the advantage drawn by product originators from widening information asymmetries.[1] The use of complex structures facilitates product differentiation and focuses competition on elements other than on price (Célérier & Vallée, 2012).

Information asymmetries are also present between originators and distributors. Research has found evidence of poor professional skills among sale representatives and financial advisors who failed to understand the risks and characteristics of the products they sell (FSA, 2007). Innovation in product structuring exacerbates this problem, unless continuous training is provided.

Therefore, innovation in investment markets may lead to growing product complexity also for more professional investors (FSA, 2007; IOSCO, 2012), even though there are also cases in which innovative product structuring can simplify the understanding of the risk by the investor. Innovation is driven both by supply and demand factors and can increase choice in the marketplace to the benefit of investors. However, innovation may lead to higher product complexity in two respects:

- *Greater information asymmetries*, by bringing in potential difficulties for investors to understand the pattern of costs/returns and the risks embedded. Some features are unclear even to experts, let alone to retail investors.
- *Strategic use to capture additional consumer surplus.* In effect, by making product attributes harder to observe and compare, the competition shifts to branding and other spurious features, leading investors towards random decision-making at the margin. A good example is a product offering a high return but linked to a low probability scenario to attract clients, who struggle to balance the two aspects in their investment decisions (IOSCO, 2012). Moreover, innovation may be used to reset accumulated knowledge and experience, keeping the pool of unsophisticated investors stable over time (Célérier & Vallée, 2012). [2]

There is also evidence that the sale of packaged financial products tends to be more lucrative than the sale of plain vanilla securities (IOSCO, 2012). However, when investors (in particular smaller ones) demand features associated with complex product structuring, such as capital protection, it becomes difficult to disentangle demand factors from supply factors. As a consequence, financial innovation requires carefully balanced supervision to avoid, on the one hand, hampering liquidity and investor

[1] In this paper, packaged financial products are all financial products that have a manufactured component linked to an underlying investment. This manufactured component is not an asset per se, whether its underlying is a physical asset or a financial contract (e.g. swap). Units of investment funds (e.g. UCITS ETF) or unit-linked insurance products would therefore be considered packaged financial products.

[2] Anecdotal evidence suggests the presence of strategic behaviour in the marketplace. For instance, packaged financial products distributed by high-street banks tend to be more complex than those offered by private banks or wealth managers (Célérier & Vallée, 2012).

choice and, on the other, mitigating potentially adverse effects of strategic behaviour, at both the point of origination and sale.

1.1.1 Inability to observe or benchmark performance

Many financial products and services qualify as so-called 'credence' goods, which means that their performance is difficult to observe or benchmark even after purchase. An investor purchasing an equity fund will observe the interim performance of the fund at given intervals but will not be capable of assessing the overall performance until redemption. Moreover, the overall performance of the individual fund will say little if it cannot be compared or benchmarked against the performance of similar funds, while simply establishing the universe of comparison will be problematic. Investment advice is a further example of a credence good, where the quality of the service purchased cannot be established, even after consumption, because benchmarking cannot be properly performed against an infinite set of potential scenarios (Darby & Karni, 1973).

The credence attribute, which is the prevailing characteristic of financial services and products (Pacces, 2000), may crowd-out high-quality products, through a process generally defined as 'adverse selection'. Since the inability to observe performance prevents investors from inferring higher quality with higher prices anymore, this situation facilitates product differentiation based on branding and other non-substantial elements. It also explains the high weight carried by 'trust' in determining investment decisions (Chater et al., 2010). To a large extent, trust is as an emotion based on psychological impressions used by the investor to forecast the expected quality of the service.

1.1.2 Switching costs

Moreover, experience and credence attributes entail transaction-specific investments (sunk costs) that deter clients from switching providers (Renda et al., 2009 p. 97). As mentioned, investors compensate for their inability to observe performance by relying on trust, which in turn is gained through previous interactions with the service provider (FSA, 2002). Such interactions represent the sunk cost that the investor would forego if it changed providers – while facing at the same time the cost of establishing a new relationship.

Switching costs in financial services are generally high, especially for small investors. They include:

i) Transaction costs, such as search costs, information costs or learning costs related to complexity and information asymmetries;
ii) Exit costs, such as exit fees, penalties or conditional rebates on other products linked to contractual terms and conditions;
iii) Uncertainty costs, due to the experience and credence attributes present in the products and services; and
iv) Psychological factors, closely related to behavioural biases, for instance procrastination or overconfidence in the quality of the provider (Renda et al., 2009, p. 103).

The difficulty in switching providers lessens competition, reduces consumer mobility and facilitates the sale of additional products to 'captive' customers, including through tying and bundling. In effect, switching costs explain the strength of 'universal banking', whereby banks offer to their clients a full range of products and services beyond current accounts and ordinary means of payment, including investment products and insurance. In so doing, banks benefit from the trust established with their clients over the lifetime of their relationship. As a result, banks are well placed to assess the profile of their investors, possessing knowledge about their income and wealth. However, there is a downside to this knowledge: the more captive the client base, the higher the risk of exploitation.

1.1.3 Conflicts of interest and opportunism

Conflicts of interest can be defined as the juxtaposition of the duty of the provider to act in the best interest of its client versus its own interest (maximising its revenue, as a provider). For instance, a distributor may push the sale of an investment product based on the commissions paid by the originator rather than on the interest of the investor. Evidence of commission bias has been well documented (FSA, 2002) and recognised in the marketplace. In a survey among investment professionals accredited by the CFA Institute, 65% of respondents affirmed that sales were driven by the fee structure rather than client interest (CFA, 2009).

The interest of two different clients may also conflict, for instance, where a broker agrees to place a given issuance of securities among its clients. Here the interest of the issuer may conflict with the interest of some investors not to invest in that particular issuance (e.g. for diversification reasons). Another example is the preference given to the execution of trading orders by some clients. Ordinarily, the firm will maximise its revenue by giving preference to the interest of some clients over others (Walter, 2004).

The incentives driving conflicts of interest are sometimes less clear and more difficult to observe. For instance, some investment products are suited to offload risks or exposures away from the originator's balance sheets and/or to help the originator gather additional liquidity or own resources. Examples of products that might be used for such purposes are packaged products equivalent to hybrid capital or synthetic exchange traded-funds (ETFs) but also more plain-vanilla products used in transactions such as securities lending. The presence of a conflict of interest does not in itself entail damage the interest of investors. However, there are examples where damage has occurred, for instance, in the strategic sale of 'preference shares' to small investors in Spain until was recently banned.

1.2 Behavioural biases

Behavioural biases lead individuals to make sub-optimal decisions, in violation of the principles of rationality, given the prevalence of cognitive limitations and psychological factors. The presence of behavioural biases is yet another reason for public intervention in investment markets, in order to mitigate both their direct influence on investors and the potential exploitation by manufacturers and distributors.

In describing human behaviour, policy makers only started to consider limitations and biases in recent years. In effect, traditional economic theories and models are based on the premise that individuals behave rationally. A 'rational' behaviour implies meeting five assumptions (Debreu, 1987):

i) Completeness, i.e. individuals are able to compare alternatives and to make a ranking;
ii) Transitivity, i.e. if an individual prefers A to B and B to C, so she would then prefer A to C;
iii) Invariance, i.e. the individual should be indifferent to how baskets of goods with the same utility are presented;
iv) Monotonicity, i.e. 'more is generally good' and does not influence preferences between two goods with the same utility; and
v) Dominance, i.e. the mean of choices with same utility is always preferred or if one of the alternatives has a slightly better feature, it should be preferred.

In practice, however, the human behaviour systematically violates these five assumptions, as cognitive limitations and psychological factors bound pure rationality and make human behaviour more contingent on context and less predictable.

More specifically, three cognitive limits may induce the violation of rational assumptions (Jolls et al., 2000):

i) Bounded rationality;
ii) Bounded willpower; and
iii) Bounded self-interest.[3]

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[3] For instance, the 'overconfidence bias' means that "people tend to overestimate (to be overconfident about) the probability of an outcome if an example of the event has recently occurred (linked to the prospect theory and the precedent behaviour). Therefore, consumers are generally overconfident in their abilities and in their future

Bounded rationality (Simon, 1957) refers to limits faced by human beings in terms of accessible information, mental capacity and available time. It should be distinguished from rational ignorance in which the investor is not able or finds it inconvenient to put effort into understanding a clear set of information in a specific amount of time. In addition, individuals are often 'path-dependent' in their choices, especially when they cannot fully appraise the value of something they already possess (Korobkin & Ulen, 2000; Sunstein, 2000; Jolls, 2007). Bounded willpower, instead, leads people to act in conflict with their long-term interests, even though they anticipate negative effects in so doing (e.g. smoking, overspending today instead of saving for old age). Finally, bounded self-interest may push people to care about treating others fairly because they want to be treated in the same way. Agents will act 'nicer' or 'nastier' depending on how the other party treats them.

Behavioural economists have researched and categorised biases, with useful lessons for public policy and investor protection (Avgouleas, 2006; Tapia & Yermo, 2007; De Meza et al., 2008; Collard, 2009; Chater et al., 2010). Biases are present at the different stages in establishing preferences for decision-making and judging different alternatives (Valiante, 2008, p. 24):

- In forming their *judgement*, investors' preferences are very much influenced by past impressions and emotions, as opposed to factual analysis, and they tend to ignore disconfirming evidence. Most judgements are inferred from readily available or familiar information, which explains for instance the tendency to overestimate future gains in bullish markets. In effect, judgements are largely based on reference points, which can be anchored and adjusted by the investor in a self-serving fashion as well as by interested third parties.
- Investors' preferences in the *decision-making* process are shaped by loss aversion, meaning they are more sensitive to losses than gains (framing). Loss aversion manifests itself in different ways, such as a reluctance to sell at a loss, as a decision perceived as a 'loss' will make individuals more risk-seeking. Asking a higher price in a sale than one is willing to pay in a purchase reflects the endowment effect, which is a bias combining loss aversion and the status quo. In addition, most investors would prefer a small gain today over a larger one tomorrow – in other words, they apply disproportional discount rates.
- Social preferences and cultural factors also influence individuals' behaviour, meaning that biases depend on background to some extent. Some countries for instance exhibit high savings rates and low consumer debt, in contrast to the preference for immediate gains observed in other regions. Investors are also prone to delay the moment of taking a decision and base their action on insufficient information. Individuals have a tendency to procrastinate, which explains for instance why they shop around very little even for important purchases.

The credence attributes of investment services can magnify the effects of cognitive limits on judgment and decision-making processes. These biases expose investors to framing by third parties, including originators and distributors who may behave strategically. For instance, the purchase of a higher-margin product may be strategically induced via information overload and the anchoring of expectations (e.g. "Outside clients get 4% but with your history at our branch I could bargain for 5%"). Product structuring can also be devised strategically to profit from behavioural biases. For instance, investors tend to overestimate the probability of a favourable outcome if it depends on several specific conditions rather than a general one, a bias that can be easily exploited by structuring the product in such a fashion (Célérier & Vallée, 2012, Table 7). Policy responses to behavioural biases range from the targeted design of educational programmes to the factoring of biases in regulation and institutional design. Annex 1 provides an overview of policy responses, which are also considered in the next sections.

fortunes. For example, many people invest, believing that they can beat the stock market, or they underestimate the risk that illness or unemployment may cause difficulty in repaying a loan" (Jolls et al., 2000, p. 54).

Table 1. Selected behavioural biases affecting preferences in the decision-making process

Judging Alternatives	Making Decisions
• Self-serving bias	• Procrastination
• Optimism	• Information overload
• Anchoring and adjustment	• Overconfidence
• Representativeness heuristic	• Framing
• Hindsight	• Loss aversion
• Social preferences	• Immediacy or hyperdiscounting bias
	• Endowment effect

Note: See Table A1 in the Annex for a more complete presentation of behavioural biases and suggested policy approaches.

Source: Authors' own elaboration based on Chater et al. (2008) and Valiante (2008).

1.2.1 The individual circumstances

From a micro-perspective, investor protection is aimed chiefly at fostering incentives for individuals to participate in financial markets, by promoting savings, smoothing consumption and increasing future income security. Investment decisions are crucial for individuals, in particular for those with fewer resources, since investing may put their financial security at risk. Their importance is also paramount when it comes to preparing for the long-term, including retirement. Overall, investor protection facilitates the allocation of capital to those that value it more.

Uncertainty and risk are inherent in any investment process; the principal invested is invariably at risk, either explicitly or implicitly, given the counterparty risk. Market and non-market risks are the main determinants of performance. However, leaving risks aside, the final outcome for investors also depends on product adequacy and costs. A product is adequate for an investor when it matches its individual profile, which is given by i) its ability to bear potential losses without putting its basic financial security in jeopardy and ii) its preferences in terms of risk and return, given that some investors are more comfortable with lower risks than others (e.g. capital protection). Costs (fees and expenses) also determine the outcome of the investment process, since they can significantly reduce net performance – for instance, an annual administrative charge of 1% of a pension accumulation will reduce the total accumulation by as much as 20% (Barr & Diamond, 2010; De Manuel, 2013).

But beyond objective adequacy and costs, there is a subjective dimension that is at least as important. Subjective adequacy could be defined as the alignment between the characteristics of the investment product and the individual's expectations. A product may be objectively adequate for an investor but if s/he does not understand how the product works and the risks embedded, there is a high probability that the investment process will lead to an unsatisfactory outcome. Expectations are difficult to manage given behavioural biases, which also shape individuals' reactions versus investment outcomes. An experiment conducted in the UK to understand reactions to volatility and loss showed that irrational behaviour is linked to the lack of familiarity with investing rather than the non-provision of relevant information before investing (NEST, 2010). In this experiment, individuals played a simulation where they invested in a private pension, having received information about the functioning of the investment, including the likelihood of interim losses. When interim losses materialised in the simulation, those individuals who were less familiar with investing reacted with surprise and anger – they felt 'cheated' out of the money, 'robbed or 'misled' and looked for someone to blame or punish (NEST, 2010, p. 31). These individuals perceived themselves as 'passive victims' rather than active investors. The experiment illustrates that disclosure is not enough to ensure product adequacy since some investors are unable to process the information disclosed.

1.3 Financial capability and generic advice

Financial education and generic advice are first-order tools to improve investor protection and overcome market failures. These tools can improve financial capability, i.e. equipping individuals with the knowledge and skills to meet their current and future consumption needs with their available resources. In effect, a lack of knowledge and interest are the main reasons why people do not invest, followed by a lack of available resources (FSA, 2011a, p. 16). Where people overcome inaction and do invest, insufficient financial capability will ordinarily lead to second-best outcomes. In facilitating better investment decisions, higher financial capability holds the potential for individual and collective welfare gains.

Financial capability is difficult to concretise, observe and measure in practice. Research conducted for the FSA identified five specific domains or areas of financial capability (PFRC, 2006). Three of these areas directly affect the process of making investments:

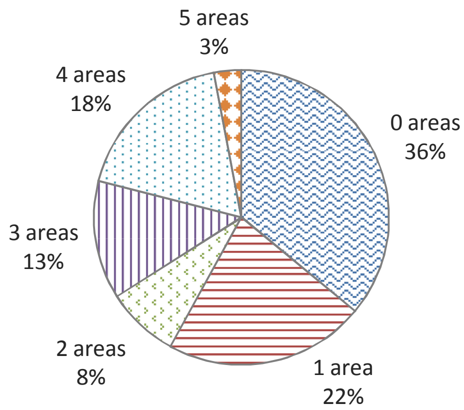
i) Planning ahead (the ability to anticipate and prepare for future financial needs);
ii) Staying informed (the monitoring of changes in the market for financial products, advice services and the wider economy); and
iii) Choosing products (knowledge, attitudes and behaviour towards financial products and their purchase).

While the other two areas identified by the FSA refer to more basic abilities:

i) Keeping track (the ability to monitor day-to-day spending and finances); and
ii) Making ends meet (the ability to meet expenses with available resources).

A 2006 survey estimated that only 36% of the UK's population was capable in the five domains. Conversely, about 64% of the UK's population had one or more weak areas, as represented in the figure below.

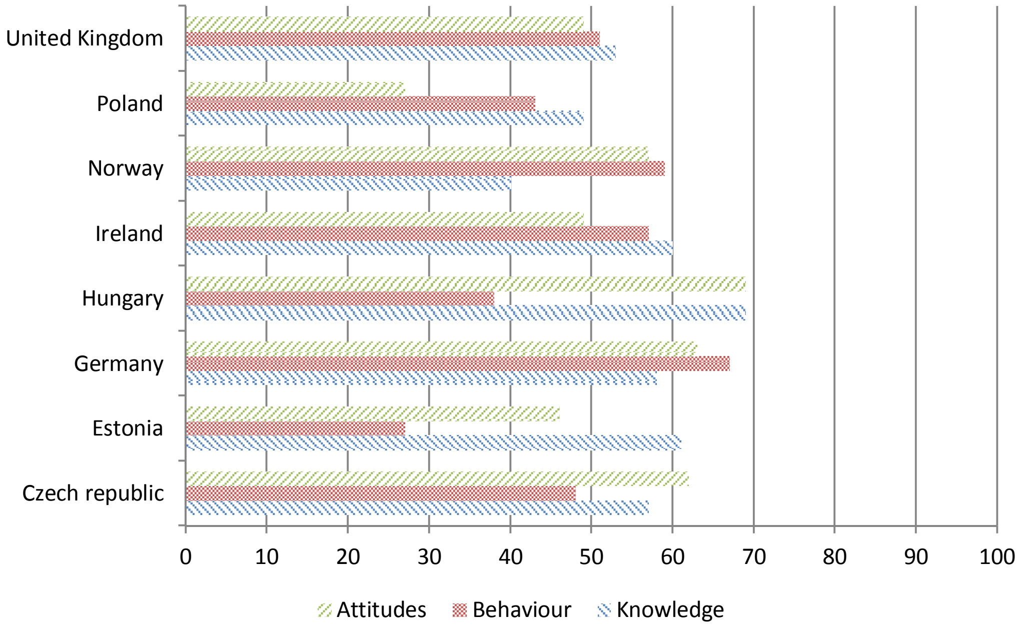
Figure 1. Financial capability in the UK (% of population with strong areas)



Source: PFRC (2006).

The OECD International Network on Financial Education (INFE) has also developed a framework to measure financial capability along similar lines (Kempson, 2009). In 2010-11, a pilot survey was carried-out in 14 countries, including six EU member states and Norway (figure below). The results reveal that literate individuals make up on average less than 50% of the total population (Atkinson & Messy 2012). For instance, less than half of the respondents seemed to understand the impact of compounding in every country surveyed but Norway (46%). Even more worryingly, in terms of behaviour, very few individuals appeared to shop around and seek independent information or advice – the maximum score belonging to the UK (16%).

Figure 2. Financially literate population in selected OECD countries (% of population in each domain)



Source: Atkinson & Messy (2012).

Aptitudes and emotions limit the effectiveness of traditional approaches to financial education in raising the level of financial capability (De Meza et al., 2008). In an experiment conducted by NEST (2010), explanations given to individuals about the functioning of long-term investment products were not assimilated – when confronted with interim losses, individuals reacted irrationally, exhibited surprise and were inclined to stop contributions. However, in the same experiment explanations given about the impact of inflation on the value of pensions were well assimilated. In effect, individuals process information selectively.

To achieve lasting effects on knowledge and behaviour, the design of financial education programmes is crucial and should:

i) Focus not solely on formal learning but also on practice and behaviours;

ii) Intervene early, with specific programmes directed at children and young adults; and

iii) Continue to be readily available through adulthood, including through the provision of generic advice.

Traditional education is effective in raising arithmetic and statistical skills, which are highly correlated with financial capability. For instance, investors make worse decisions where fees are framed as percentages or not compounded returns (Chater et al., 2010; Atkinson & Messy, 2012). In effect, poor statistical and maths skills lead investors to estimate probabilities wrongly, returns and costs, which producers and distributors can exploit. Generic education in these fields should ideally be complemented with specific practice in a financial context. It has been consistently found that practice at looking for and purchasing financial products is a key determinant of financial capability (Chater et al., 2010; PFRC, 2006). Learning by doing is indeed effective, in particular if feedback is provided (HM Treasury, 2008).

Changing attitudes and emotions, however, is a challenge even to meet over the long-term, and the effect of de-biasing techniques on investors has not been the subject of significant research. There is evidence that making investors aware of biases is not always effective and may even at times be counterproductive (De Meza et al., 2008). Some de-biasing techniques could, however, be part of hands-on education programmes. These mostly aim at educating individuals about the decision process. De Meza et al. (2008) found, for instance, that considering opposite scenarios is a useful tool for encouraging individuals to be critical of their own decision-making, to avoid overconfidence and to limit the suppression of disconfirming evidence. Individuals who imagine they explained their own choice to others have also been found to make better decisions. Individuals would therefore be taught techniques to improve the management of their own decision-making. Other de-biasing techniques are more apt to be built into regulation and institutional design. For instance, procrastination can be mitigated by automatic enrolment in saving programmes. And information overload can be lightened through the standardisation of summary disclosure. Yet, some biases persist despite high levels of financial education and extensive experience in financial markets. A number of experiments have found that MBA students and finance professionals are prone to similar biases and irrational behaviours as the average retail investor (De Meza et al., 2008).

Generic (non-commercial) advice merits separate attention. Formal education programmes take place during childhood and youth, but financial decisions are taken during adulthood. By generic advice, we refer to the provision of education resources and personalised guidance to adults. It is not a product sales channel but an educational tool; the provision of recommendations to purchase or sell specific products is not generic advice. Individuals need generic advice to find answers to problems such as:

i) Deciding whether to save or invest;
ii) Choosing an investment product;
iii) Understanding investment fees;
iv) Choosing a commercial adviser and knowing what questions to ask; or
v) Reacting to a case of misselling.[4]

Generic advice can be very useful, for instance, in helping investors to overcome their naiveté about conflicts of interest and inducements and to understand the differences between product categories and the concepts used in basic information sheets. Such background information is generally not available elsewhere, and increasing investors' familiarity with products and agents fosters participation in retail investment markets.

2. A 'life-cycle approach' to investor protection

Public intervention to protect small investors is needed throughout the whole life-cycle of the financial product, from the origination to the sale of the investment product and from its purchase to redemption. A partial approach to investor protection might be ineffective, while imposing sizeable costs on originators, distributors and ultimately end investors. We define partial approaches as those that only address one phase of the long process involved in the product life-cycle. An uncoordinated and piecemeal approach neglects the importance of market failures, such as behavioural biases, that affect the proper understanding by the investor of the risks involved in holding a financial instrument during its life-cycle. Increasing investors' understanding of the risk during the life-cycle of the product may also ensure a longer holding period of savings and avoid investments being driven by risk aversion due to cyclical macroeconomic factors, which can ultimately hamper liquidity of assets with long-term maturities.

The ordinary life-cycle of a financial product can be split into four phases:

i) Design and origination of the product by the manufacturer, such as a fund manager;
ii) Wholesale distribution of the product, where the manufacturer/issuer agrees with the distributor/intermediary the conditions for the sale of its products to the end investors, which may

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[4] These sample questions are taken from selected sections of the website of the Money Advice Service (www.moneyadviceservice.org.uk). The Money Advice Service is a UK-wide service offering generic non-commercial advice online, by telephone and through a network of money advisers, established by the Financial Services Act in 2010. Similar websites exist in other countries; In France, for example, see "Le Site Pedagogique de l'Argent et de la Finance" (www.lafinancepourtous.com), which however is a public-private partnership. Some private providers have launched similar websites; see for instance Royal Bank of Scotland's MoneySense (http://rbsmoneysense.co.uk).

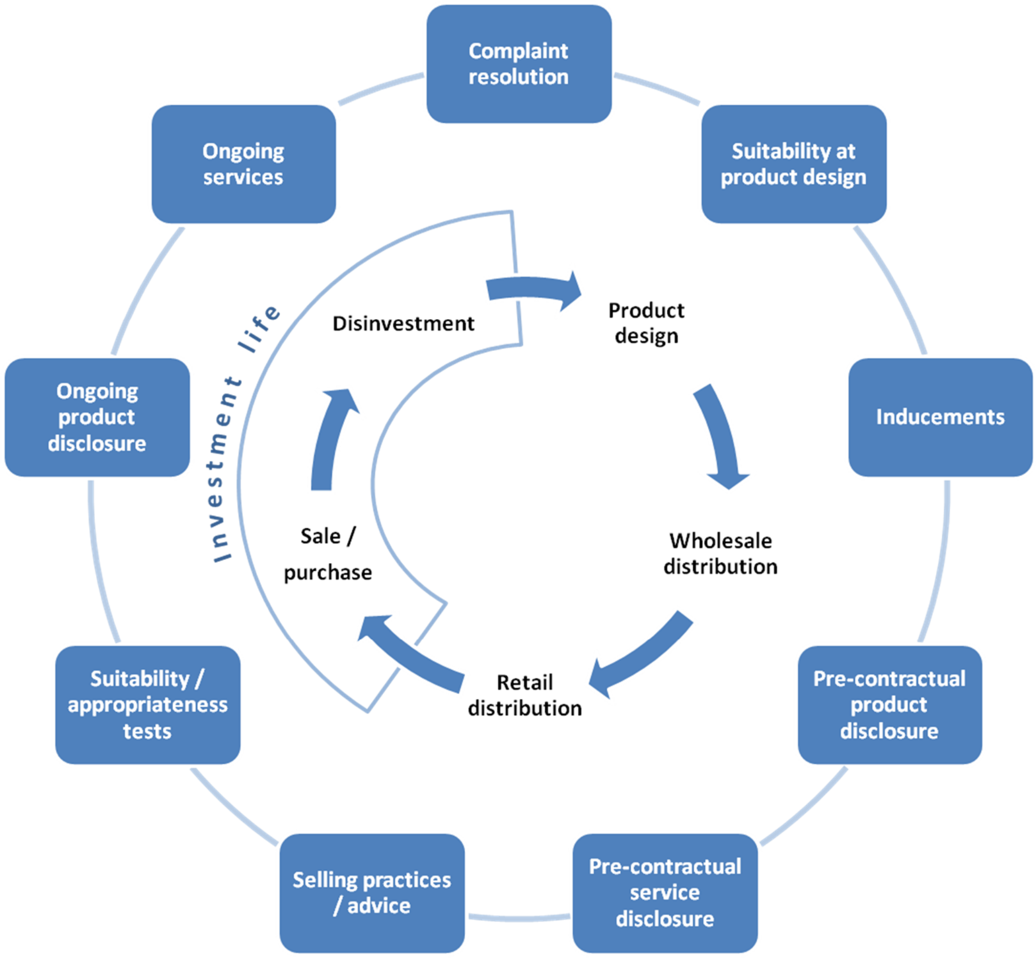
also include a fee paid by the originator, such as the training and fees provided by a fund management house to the sales representatives of a high-street bank;[5]

iii) Retail distribution where the end investor purchases the product, whether from a high-street outlet or through the internet; and

iv) Duration of the investment itself, which runs from the time of purchase to the exit by the end investor.

Figure 3 presents the product life-cycle and the appropriate tools of investor protection, which will be later explained.

Figure 3. A life-cycle approach to investor protection (phases and tools)



Source: Authors' own elaboration.

At each stage in the product life-cycle, the range of issues that warrants investor protection is different and so is the nature of the tools needed. The product life-cycle should be seen as a whole, however, and selected intervention at each stage would only make sense if coupled with measures in other stages of the product life-cycle. Information asymmetries run across all the phases in the cycle and affect both the relationship between end investors and distributors and between distributors and product providers, to varying degrees.

For end investors, asymmetries of information are present before and after the purchase, whether a simple lack of information led by the opportunistic behaviour of the counterparty or a structural lack of knowledge due to the nature of the product/service. The difficulties in observing and benchmarking

[5] For the Initial Public Offering of shares or for the collocation of bonds, however, the commission is typically paid by the investor directly to the intermediary.

the performance of financial instruments (credence goods) typically remain after the investment ends. Conflicts of interest and behavioural biases are the most visible manifestations of such asymmetry of information. Conflicts of interest are mainly present at the design and distribution phases where originators and distributors try to maximise the return on their investments by extracting as much consumer surplus as possible. While maximising returns in the long-run would lead to serving investors' interests, market imperfections, the seeking of private rents and myopic behaviour tend to lead to the short-term maximisation of returns, even when it runs against the interests of investors. Behavioural biases are most relevant during the sale process, where, on the one hand, the framing of choices may lead the investor to make inadequate investment and, on the other hand, distributors may exploit certain biases to their advantage. Yet, behavioural biases are also relevant after the purchase where the investor may engage in 'buying high and selling low' due to overconfidence bias or exiting a long-term investment due to disappointing short-term performance despite favourable projections (e.g. pension products).

While intervention at each phase needs to be specific, it is possible to extract a number of basic principles that should guide intervention across all phases in the product life-cycle:

i) A general fiduciary duty by all agents towards the principle/end-investor should be recognised due to structural (e.g. behavioural biases) and opportunistic (e.g. moral hazard) information barriers.[6]
ii) Mitigation techniques for conflicts of interest should always be pursued, while the outright elimination should be subject to a cost-benefit analysis.
iii) Comprehensive disclosure should not be misleading or induce overload; it should also provide ongoing information during the duration of the contract.
iv) Distribution of responsibilities among all agents involved in the investment decision (originators, distributors and investors) should be clear and effectively disclosed ex ante.
v) Effective redress procedures, enhanced private enforcement procedures and public supervision (with strong international coordination in the single market) should ensure that these principles are upheld in practice.

Regulation and institutional design of investor protection tools must take into account all these factors. As a result of the market failures described in previous sections, the various tools to promote investor protection can be broadly classified into three groups:

- *Know your product rules*, based on the principle that originators and distributors need to understand the risks embedded in the products they sell as well as the general adequacy of such products for the target market;
- *Disclosure requirements*, encompassing all obligations imposed on originators and distributors to disclose all relevant information to investors in a manner that investors are able to access, utilise and understand; and
- *Know your customer rules*, based on the fiduciary duty imposed on originators and distributors to act in the best interest of their clients, avoiding the sale of any products that are inadequate for them, based on some sort of assessment of the individual's circumstances.

Table 2 lists the most important tools under each of these groups, which are discussed in the next sections.

[6] For a more detailed view, please see Valiante (2011, p. 171).

Table 2. Taxonomy of tools for investor protection

Know your product rules	Disclosure requirements	Know your customer rules
• Suitability at product design • Professional aptitudes	• Pre-contractual product or service disclosure • Ongoing disclosure • Market data • Ex-post disclosure (product or service evaluation)	• Suitability and appropriateness tests • Selling practices/advice • Ongoing services • Professional aptitudes • Best execution obligation

Source: Authors' own elaboration.

2.1 'Know-your-product' rules

As part of the fiduciary duty falling on product providers and distributors, both providers and distributors are required to know their product in their respective capacities. Products need to be designed in the best interest of the investors that the product is targeting, while distributors need to understand the products they sell well enough to be able to assess their adequacy for the investor. 'Know-your-product' rules ensure that the entity structuring and/or selling the product does it in a professional and competent way that would reduce the likelihood of market failures at the source. Such rules, however, do not prevent the opportunistic use of information asymmetries, which are addressed by disclosure requirements and 'know-your-customer' rules. Rules apply to the structuring of the product, whether the latter is marketed or not to investors with a lack of knowledge (typically retail investors).

'Know-your-product' rules affect the structuring of the financial product (before issuance, especially for packaged products such as transferable units of investment funds) and thus its suitability for end investors (after issuance).

2.1.1 Product structuring rules

Public intervention through regulation can in general be rule-based or principle-based. At the level of product design, rules prescribing the structuring of an investment product are prone to be detailed and leave limited space for interpretation. Product structuring rules in UCITS are probably the best example of product regulation.[7] Among the benefits of the UCITS framework there is are the creation of a single market in Europe and the build-up of investor awareness and confidence in the quality of the retail funds complying with the framework. However, product regulation also presents a number of drawbacks, including:

a) *Obsolescence*. Continuous evolution in markets means product rules can quickly become outdated. Such changes can play against both product attractiveness in terms of exposures and returns, as well as their security, given the emergence of risks that regulation did not initially control for. To overcome obsolescence, product rules need to be open to very frequent updates. Primary legislation should be reserved for high-level principles and objectives, clearly spelled out as such to ensure coherence, while secondary legislation should be delegated to supervisors, under

[7] Product rules in the structuring of a financial product that is not plain vanilla (e.g. shares) typically set a regulatory framework on the instruments that can be used in the structuring phase (e.g. eligible assets), on how these instruments shall be combined (e.g. diversification requirements), and on how to protect the structure of the product from external market events (e.g. leverage limits, exposure to counterparties and collateral management, among others). They are different from management rules, which are concerned with the requirements that the intermediary has to face for the provision of specific services, independently of how the product they want to sell will be ultimately packaged. For instance, UCITS is an example of product structuring rules, while AIFMD is an example of requirements for the service provider.

appropriate review procedures. Under narrow delegation or unclear principles, rules will not keep pace with markets and their initial objectives. The ever-more frequent revisions of the UCITS framework are clearly related to these phenomena.

b) *Regulatory license.* The use of the regulatory license, i.e. a particularly favourable legal regime for a financial product or service, is useful in promoting participation in financial markets, but it reduces the incentives of agents to adhere to ethical and professional principles and induces a species of 'moral licensing'. This effect goes both for product providers where compliance is limited to box-ticking and for clients who fail to conduct the necessary due diligence. Moreover, the regulatory seal can provide a commercial advantage that originators will be keen to exploit, packaging as much as possible under a regulated format and even stretching the rules (e.g. 'volume-based' incentive, as for securitised products under credit ratings embedded into regulation). Some 'alternative UCITS' are a good example of this effect. In the margin, regulatory endowment fosters the expectation among investors of a possible bailout, i.e. a political and legal risk for taxpayers. Such expectations can also create more hazard for product providers.

c) *Partial representativeness.* If product regulation is the tool, its utility would probably not be maximised by a single regulated category but rather by multiple ones. Retail investors have different needs and preferences, in terms of investment horizons, liquidity, exposures, returns and risks. A single product regulation cannot cater for all products without becoming obscure or fragmented, as illustrated by the debate about product proliferation in UCITS. Partial representativeness also means that product rules may distort the optimum allocation of savings by investors.

In sum, product regulation has numerous potential benefits but it is also a complex tool for public authorities to manage. It is essential to factor the risks of obsolescence, regulatory license and representativeness into its design.

2.1.1.1 'Suitability test at product design'

'Suitability test at product design' or selection criteria for packaged financial products acknowledges the limited incentives and informational barriers that may affect the task of originators (and distributors). It refers to the set of internal policies, processes and controls that should guide the design for product originators (and selection for distributors) of financial products, in view of the client group to which each product is targeted. Despite its crucial importance, suitability at product design is not enshrined in the legislation of key jurisdictions around the globe. As pointed out by the Basel Committee on Banking Supervision, "it appears that countries do not have regulations that impose requirements on the product design process, particularly around retail products" (BIS, 2008, p 22). The revision of MiFID, however, places the responsibility on senior management for approving the policy governing the services and products offered by the firm, in accordance with the characteristics and needs of the clients to whom the products will be offered or provided (Art. 9.6.d).[8]

Doubts remain, however, on whether this approach would be sufficient to develop best practices in product design. At the origination stage, suitability at product design is different from product regulation, as it is a principle-based regulation. It should, however, embody more than a general duty of 'professionalism' or 'fairness' and extend to a minimum set of principles to be implemented in each phase of the product design process. Suitability at product design should comprise the following:

a) *In procedural terms*, the intermediary should implement suitability into the process of product design based on clear policies, while providing for a compliance check before products are

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[8] More specifically, Art. 9.6 MiFID 2 (Legislative proposal) reads: "Member States shall require the management body of an investment firm to ensure that the firm is managed in a sound and prudent way and in a manner that promotes the integrity of the market and the interest of its clients. To this end, the management body shall: […] (d) define, approve and oversee a policy as to services, activities, products and operations offered or provided by the firm, in accordance with the risk tolerance of the firm and the characteristics and needs of the clients to whom they will be offered or provided, including carrying out appropriate stress testing, where appropriate."

launched. Design should be actively engineered around the interests of the targeted category of clients, i.e. procedures should therefore "support the design of products appropriate for particular investors" (IOSCO, 2012, p. 24). General methodologies behind product structuring should be disclosed and made publicly available, as well as the departments and the individuals directly responsible for that product structuring within the company.

b) *In absolute terms,* guidelines should specify a minimum set of requirements that would make a product suitable in practice, leaving room for manoeuvre by competent authorities. Products with a pattern of return, risk or cost that may be difficult for retail investors to understand, whether they offer a balance of costs-performance that is lower or higher than the market average for less complex alternatives, should be deemed not in the clients' best interest. Products that are primarily aimed at offsetting risks in the balance sheet of the originator, without being offset by enhanced performance for investors, should also face close scrutiny.

c) *In supervisory terms*, suitability at product design requires a commitment to active supervision. IOSCO (2012) proposes frequent thematic reviews, on-site and offsite visits, as well as the use of risk-based methodologies to prioritise enforcement actions. It also invites regulators to make such actions public to enhance market integrity and protect investors. For instance, at EU level, more coordination among national supervisory practices and regulations would be necessary to achieve consistency and reduce market distortions.

Being largely uncharted territory, suitability at product design will need to be developed over a sufficient period of time, perhaps with a phasing-in period. Its ability to raise consumer surplus and to reduce misselling, although promising, is not clear yet and will depend mostly on implementation and supervision. If successful, it could open the door to dropping existing product rules.

As a consequence, in effect, the suitability test at product design may bring some clarity in MiFID in relation to the long-standing question as to when a product should be deemed 'complex'. There is a growing concern among regulators and supervisors that intermediaries may use product complexity (i.e. the understanding of risk, returns and costs) opportunistically to the detriment of investors, in particular by obscuring costs, risks and returns to extract a higher surplus or raise own resources. Suitability at product design would, in effect, shift the attention of supervisors to the investors' understanding of returns, costs and (market and non-market) risks for the product under all potential scenarios, thereby avoiding an expression of preference for a specific asset class and bearing in mind that the product would have been designed with the level of sophistication of a specific target audience in mind.

Furthermore, exposure to sudden illiquidity or an issuer's credit risk, as well as the use of financial leverage, is another relevant concern for supervisors (IOSCO, 2012). While product complexity remains largely undefined, it is the impact of complexity on suitability that matters. Products that are designed in a way that the risk-reward profile and costs cannot be disclosed in a standardised format, such as the key investor document or KID, could be deemed as excessively complex and generally unsuitable for non-professional investors. Such complexity in the risk-reward profile frequently arises from complexity in the product structuring, although a complex structure does not necessarily make the product risk-reward profile difficult to understand. Yet, in determining the risk-reward profile of a product, not only the expected returns and market risks matter, but also any non-market risks and all costs related to the product, which are typically associated with complex structures.

Suitability at product design would therefore reduce the likelihood that complex products whose risk-reward profile and costs under all potential scenarios cannot be easily understood will be delivered to non-professional investors, since the product is already designed with a category of investors in mind. Should the ex-ante test for suitability at product design be unable prevent complex products from reaching non-professional investors, supervisors may consider completely banning their sale to non-professional investors or the exclusion of the product from execution-only services, non-advised sales or sales with pre-sale information services (influenced by inducements).

2.1.2 'Know-your-product' at distribution

In addition to the duty of distributors to assess 'suitability at product design', as described above, regulators and supervisors need to provide an answer to the endemic problem of insufficient professional standards, in particular at distribution. There is abundant evidence that advisers and sales representatives fail to understand the characteristics and risks of even relatively simple products (FSA, 2011b). The UK, for instance, has introduced policies to raise the level of the professional qualifications that sales representatives both in advised and non-advised sales should meet. It has also introduced continuous professional development programmes of at least 35 hours per year, so that sales representatives are kept up-to-date with market innovations. At EU level there is so far no common approach except the one proposed by ESMA (2011), which is based on supervisory coordination. If required by national regulations, professional training is typically done by national bodies and no harmonised approach to training currently exists, while financial advice is 'passported' at EU level (through MiFID rules).

Finally, with suitability being applied at product design with regard to the characteristics and needs of the targeted investors, the duty should apply to originators independently of the distribution channel through which the product is finally delivered to the end investor. Distributor and originator shall be jointly liable if the product is unsuitable at its design for end investors. This would impose a duty on the distributor to evaluate the suitability of the product structure before the product is put on sale for non-professional investors.

2.2 Disclosure requirements

2.2.1 Basic principles of disclosure

Comprehensive and not misleading disclosure plays an essential role in markets where information asymmetries are prevalent, such as the market for retail investment products. Without disclosure, investors would not be able to make informed investment decisions. In this context, imposing disclosure requirements via public intervention serves two objectives:

i) It reduces the costs involved in gathering and understanding information to promote investor participation by providing complete and not misleading information; and

ii) It facilitates comparisons across products and services to facilitate the best choice and stimulate competition. Public intervention would therefore be justified by the difficulties in processing abundant and complex information and the susceptibility of investors to framing by intermediaries, thereby reducing ex ante the likelihood of misselling practices.[9]

For retail investors, in particular, three types of disclosure requirements are relevant in financial markets. A first-order disclosure pertains to the nature and characteristics of the products and services before the sale and during the execution of the contract (ongoing disclosure). This first-order disclosure reduces the likelihood of misselling and most importantly, the risk of fuelling adverse selection, i.e. the systematic inability to assess the quality of a product ex ante, which would end up pushing high-quality products out of the market (at least products for retail investors; Akerlof, 1970). Pre-contractual and ongoing disclosure also ensure that investors can evaluate performance, at least for those characteristics of the product that so allow (non-credence attributes). It therefore helps to create a reputational market for investment products. Often, market dynamics in Europe have been driven by the degree of accessibility to distribution channels rather than the reputation of originators in delivering returns to final (retail) investors. A second-order disclosure, instead, would address any conflict of interest that cannot be eliminated and need therefore to be disclosed to the client and the market. Both first- and second-order information are relevant to individual investment decisions and

[9] From the perspective of behavioural economics, the costs of being rational are high given the need to acquire and process information (De Meza et al., 2008, p. 20).

to determine the adherence of the intermediary to its fiduciary duty. This paper focuses on first-order disclosure only.

2.2.1.1 Four-step approach to investor disclosure

To achieve the two objectives above, regulation can use a four-step approach to the problem, in particular through:

i) High-level principles, such as "disclosure should be comprehensive and not misleading", while "any information should be communicated in a concise and clear manner";
ii) Standardisation of the disclosed content, i.e. the categories of information that the intermediary should disclose to the investor;
iii) Standardisation of the form of disclosure, with reference to the presentation of disclosure, in particular for summary disclosure; and
iv) Disclosure of the procedures to follow in order to obtain more information, file complaints and obtain redress.

In addition, financial education and generic advice can be helpful in informing investors about how information should ultimately be read and utilised.

Standardisation presents a number of trade-offs, since it may misrepresent the nature of risks in certain products, lose pace with market developments, induce 'moral licensing' in intermediaries or even inhibit the disclosure of relevant risks if they do not fit within the given format. However, standardisation appears as a necessary tool to ensure that investors can access some form of summary disclosure that is comparable across products and intermediaries. Enough flexibility is needed so that intermediaries are given the room to disclose all relevant information, even in summary documents. Notably, however, standardisation should not be allowed to remove liability for incomplete, incorrect or misleading information.

The next sections examine the current framework for pre-contractual, ongoing and post-trade disclosure in the EU and make some policy proposals.

2.2.2 A framework for disclosure requirements

This section assesses two levels of disclosure currently present in the regulation governing the provision of financial services and products: pre-contractual and ongoing disclosure. This section does not deal with pre-trade or post-trade market transparency (e.g. price and volumes) of instruments listed on legally-recognised trading platforms for trading purposes.[10]

2.2.2.1 Pre-contractual

Pre-contractual information plays a central role in retail contracts, where the terms and conditions are set ex ante and the consumer has little or no bargaining power. In many jurisdictions, pre-contractual information is incorporated into the contract and may take precedence over formal terms and conditions in the interest of the consumer. Beyond the rights potentially conferred on the consumer, pre-contractual information plays an essential economic role, mitigating asymmetries of information and facilitating choice. There would be no markets without pre-contractual information, and even more so for limit order books of some plain vanilla financial instruments (such as shares), which bring together all sorts of buying and selling interests. Most notably, in particular when dealing with credence goods, the absence of any ex-ante way to signal the level of risk embedded in a financial product would increase distortions in its pricing, as fewer investors will be able to have even a partial evaluation of the product ex ante. High-quality products would therefore be increasingly mispriced and pushed out of the market.

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[10] For an overview of the theoretical background behind pre and post-trade transparency requirements for trading, please see Valiante (2011).

In the market for investment products, when dealing with retail investors, the importance of pre-contractual information is even more acute, given the complexity of the products on sale and the importance of individual investment decisions. The effectiveness of disclosure therefore also depends crucially on its length and form, which can expose investors to framing and information overflow. The full disclosure of every legal term, which is not necessarily relevant for understanding the risk-reward profile, has proved counterproductive because of its length and complexity. Instead, evidence suggests that summary disclosure in plain language is effective in helping investors to make better investment decisions (Chater et al., 2010).[11] From a behavioural perspective, disclosure fosters the feeling of ownership over the investment decision, with positive effects for instance where it comes to coping with intermediary losses (NEST, 2010). The hard task is to ensure that content selection keeps the underlying bulk of information conveyed to the investor complete and not misleading, in order for him/her to take an informed and smooth investment decision. Most notably, the level of pre-contractual details to be disclosed also depends on the level of complexity in product structuring. Plain vanilla products, such as shares and short-term bullet bonds, may require a less complex regulatory approach. Packaged products, such as units of investment funds or derivatives, may require a different level of information disclosure in the pre-contractual phase.

2.2.2.1.1 The 'KID' format and non-market risks

The European Commission has proposed the creation of a standard for pre-contractual disclosure, which is called the key information document (KID), under a regulation put forward by the European Commission in July 2012.[12] The document is based on two principles:

i) Selective content, of short length and clear language to facilitate understanding and get the most important information across; and
ii) Standardised layout, risk, cost and performance indicators to facilitate comparison and choice.

Originators draft the document and distributors provide it to clients in advance of their purchases. The obligation to provide a KID would apply to so-called 'packaged retail investment products' or PRIPs, i.e. packaged products such as units of investment funds, unit-linked insurance and other packaged products.[13] It is this element of 'packaging' that adds a further layer of complexity and necessitates a particular standard of disclosure, both in terms of risks and costs. A similar initiative could apply to equities and bonds to facilitate comparability of investment decisions.[14] The proposed KID builds upon the experience gathered in UCITS, where a similar standard has operated since July 2011.[15] But crucially the aim of the KID is not only to allow a comparison among products of the same category (e.g. between fund A and fund B) but also between different categories of products (e.g. between fund A and unit-linked insurance C). Fostering comparability across different types of packaged financial products is crucial since most of these products may appear as close substitutes from the viewpoint of the final investor. But disclosure should also help investors identify the characteristics that differentiate one product category from another.

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[11] In a survey conducted in 2011 by the UK's Financial Services Authority (FSA), 60% of the respondents said they read the key features document (KFD) in full or in part, while 80% said the document helped them in decision making. Almost 30% of individuals, however, said they did not receive the document or could not recall the reception (FSA, 2011a). The KFD is similar to the key information document (KID) proposed by the European Commission (2012) for PRIPs.

[12] Proposal for a Regulation of the European Parliament and of the Council on Key Information Documents for Investment Products, COM (2012) 352/0169, 3 July 2012, European Commission, Brussels.

[13] For a full definition of the field of application of the KID, see De Manuel (2012).

[14] Equities and bonds, however, are subject to the prospectus Directive (2010/73/EC).

[15] Key investor information document or KIID under Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website.

Most importantly, disclosing non-market risks appears as an essential element in this respect. Non-market risks may be defined as those that do not depend on market developments such as changes in the value of the underlying assets, currencies or interest rates. They arise on average at a lower frequency but with a higher impact than market risks and are more difficult to measure and represent. Operational, counterparty and liquidity risks are some examples (De Manuel, 2012a). Non-market risks appear as one of the defining characteristics to distinguish different categories of PRIPs. For instance, an investment fund and other packaged products are not equivalent even if based on the performance of the same underlying. In a traditional investment fund, the end investor holds the beneficial ownership over the underlying assets, which need to be segregated and placed under the purview of an independent entity (depositary). In a packaged product, offering the return of the same reference assets, the investor will not hold ownership over any assets, which the originator may or may not hold, confounded in its balance sheet. In the first case, the investor is primarily exposed to the market risk of the underlying assets, while in the second case it also faces the risk of default of the product provider. At the same time, non-market risks are also defining features within each category of PRIPs. For instance, investment funds may employ derivative financial instruments or engage in practices, such as securities lending, that result in specific non-market risks.

Pre-contractual disclosure has so far given insufficient attention to non-market risks. While UCITS are required to disclose in the key investor information document (KIID), it is uncertain to what extent disclosure takes place in practice – the obligation depends on the materiality of the risk but little specific guidance exists in this respect.[16] Disclosure focuses instead on the summary risk-reward indicator, which considers only market risks. The proposal of the European Commission to introduce a key information document (KID) for PRIPs follows a similar approach, by requiring "warnings in relation to specific risks not fully reflected in the summary indicator".[17] Narrative disclosure or warnings alone, however, are unlikely to facilitate comparison between different products. To achieve comparability, the level of non-market risks would need to be rated and possibly graphically represented. A synthetic indicator for non-market risks would need to be based on a thorough categorisation of risks (such as counterparty risks), as well as the practices where they arise. In the absence of such disclosure, however, it is also difficult to imagine how an informed investment decision would be made.

2.2.2.2 Ongoing

Ongoing disclosure appears as important as pre-contractual information, and it becomes even more important the longer the investment horizon. It has two main functions: i) to keep the investor informed of returns and charges, helping inter alia to spur competition among providers and reduce switching costs; and ii) to inform the investor of material changes to the product (e.g. changes to the investment policy), providing the knowledge and the opportunity to exit. In contrast with the KID, no holistic approach has been put forward to date for ongoing disclosure in the European Union. Instead, there is regulatory fragmentation and limited harmonisation – as illustrated by the table below. Unregulated products face no specific requirements. A common approach to ongoing disclosure may strengthen investor protection, by facilitating understanding and consolidating the rules for marketing of packaged financial products.

[16] Art. 8.5 Commission Regulation 583/2010.

[17] Art. 8.2.e COM (2012) 352/3.

Table 3. Selected EU legislation specifying ongoing product disclosure to investors

UCITS	– Review and revision of the key investor information document[a] – Information in the event of a merger of UCITS[b] – Information in the event of a non-feeder UCITS becoming a feeder UCITS[c]
AIFMD	– Disclosure of material changes to investors[d] – Disclosure of special liquidity and redemption arrangements[e] – Regular disclosure of leverage[f]
IORP	– Information to be given to members and beneficiaries on a yearly basis[g]

[a] Chapter V, Section 6, Regulation 583/2010.

[b] Article 43, Directive 2009/65/EC.

[c] Article 64, Directive 2009/65/EC.

[d] Article 23.1, Directive 2004/39/EC (prescribing a non-exhaustive list of matters).

[e] Article 23. 4, Directive 2004/39/EC.

[f] Article 23.5 in Directive 2004/39/EC.

[g] Article 11, Directive 2003/41/EC (prescribing the detail of the information to be given yearly).

In devising a regulatory framework for ongoing disclosure, a key task would be the division of responsibilities between distributors (service disclosure) and originators (product disclosure), so as to ensure the quality and integrity of the information while avoiding duplication of efforts. With respect to reporting to clients, EU regulation (MiFID II) requires firms to communicate periodically to clients, taking into account the type and complexity of the financial instruments involved and the nature of the service provided (see table below).[18] It also introduces the notion of 'ongoing disclosure' for financial instruments, perhaps based on the realisation that over time some investment products may evolve in a manner that could make them unsuitable for individual investors.[19]

Table 4. Ongoing reporting to clients in European legislation

MiFID II	Article 25.6 (reporting to clients) in Directive 2014/65 for investment services: *"The investment firm shall provide the client with adequate reports on the service provided in a durable medium. Those reports shall include periodic communications to clients, taking into account the type and the complexity of financial instruments involved and the nature of the service provided to the client and shall include, where applicable, the costs associated with the transactions and services undertaken on behalf of the client."*
IMD 2	Article 25.4 (reporting to customers) in legislative proposal COM (2012) 360 final, replicating Art. 25.5 in MiFID II above for insurance products.

However, these provisions are general and their interpretation may be loose. There is no guidance as to the categories of services/instruments demanding periodic communication or the content of such communication to investors, nor whether the provider of the packaged product or advice should provide an ongoing assessment of its suitability and appropriateness. Moreover, the parties are free to contract or not an ongoing assessment of suitability, since such a service is not always helpful or affordable. Ongoing assessment of suitability and appropriateness may be particularly needed for

[18] See also Art. 24.4 MiFID 2, 2014/65: "Appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges."

[19] Art. 24.3 first indent, legislative proposal COM (2011) 656 final (MiFID 2): "[...] when investment advice is provided, information shall specify whether [...] the investment firm will provide the client with the on-going assessment of the suitability of the financial instruments recommended."

long-term investments, precisely because of their long-term horizon. In the UK, for instance, 60% of purchasers of long-term products were offered ongoing advice (FSA, 2011a).

Finally, ongoing disclosure may also include, for packaged financial products, periodic disclosure of cost-return performance in a format that allows comparison and, if equivalent, standardised benchmarking with alternative investment products by the client herself or by his/her advisor. These requirements would potentially promote reputational mechanisms and help the consolidation of the retail investment management industry, especially in Europe, where the sector is particularly fragmented due to high legal and fiscal barriers between member states. With no regulatory framework, there is no incentive for bad performers to disclose this information, and good performers (if confident enough about their performance over a long period) will not find bad products to benchmark their products against.

2.3 'Know-your-customer' and 'know-the-security' rules

2.3.1 Basic principles

While disclosure is a necessary condition for any transaction, it is not sufficient to ensure proper investor protection. Financial capability and behavioural biases (mentioned above), on top of potential conflicts of interests that the investment service providers might have, ultimately limit the effectiveness of disclosure. In effect, customer testing has shown that a significant share of retail investors have difficulties in understanding relatively simple financial concepts and arithmetic operations also used in the KID (IFF Research and YouGov, 2009). In addition, when investors struggle to understand one or two terms, they are not able to recognise their relevance and feel discouraged as to their overall level of understanding. Face-to-face intermediation can help investors to partially overcome some of their cognitive and behavioural limitations. An overwhelming majority of retail investments are undertaken in the context of face-to-face intermediation – approximately 80% in the EU (Chater et al., 2010) and over 75% in the UK (FSA, 2011a). Investor surveys suggest that roughly 60% of investor decisions follow the recommendation of the intermediary and only a quarter of investors make their choice entirely on their own (Chater et al., 2010; FSA, 2011a).

In the context of face-to-face intermediation, however, the investor is particularly exposed to framing and persuasion by the intermediary.[20] It is therefore essential that the interests of investor and intermediary are aligned. EU legislation imposes a fiduciary duty on investment firms to act "honestly, fairly and professionally in accordance with the best interests of the client".[21] This duty demands the intermediary to refrain from exploiting the information asymmetries and behavioural biases affecting its client. It rejects the principle 'caveat emptor' prevalent in traditional contract law (Engel & McCoy, 2002). This approach to investor protection is also recognised in US securities regulation. The 'shingle' theory, developed in 1939, provides the general clause of acting in a fair way

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[20] A large number of framing techniques can be employed at the point of sale, including for instance:

- The dilution of relevant information to divert the attention of the investor (e.g. "[...] and on the back of the document you can find all the conditions and charges; I think it is an ideal product to save for your holidays, are you planning something special?");
- The use of anchors to manage investors' expectations (e.g. "returns in the current environment are low, less than 2% [...] product X offers 3% return");
- The use of complex cost or return structures that are difficult to understand and compare, steering the investor towards a decision based on branding (e.g. "our star product 'Step-Up Opportunity' guarantees a rate of return that grows every six months until maturity");
- Sequencing information to exploit the tendency to give more weight to the aspects mentioned immediately before making the decision; and
- Playing on the individual's optimistic nature and confirmatory bias (e.g. "if you feel prices will rebound, you should follow your instinct").

[21] Art. 19.1, Directive 2004/39/CE (MiFID).

and according to professional standards when the broker puts out his shingle to market his services, whether or not the investor has an agency relationship with the investment firm (Wartman, 1978). Over the years, the shingle theory has evolved to include a fiduciary duty in case the actions of the investment firm (e.g. a broker), even if not immediately related to a client transaction, were ultimately not in the best interest of the agency relationship the firm had with its clients (Karmel, 1995).[22] This evolution in legal theory and case law, supported by the shingle theory, has allowed the application of economic theories for practices in the sale of financial instruments (Madison, 1999), in particular when there is investment advice (see Hughes vs. Securities and Exchange Commission, 1949,[23] in Leavell, 1967). The provision of investment advice in the sale of financial instruments has led the provider over the years to test the 'suitability' of the advice for the investment decision ('know-your-customer' rules). For 'non-advised' sales, however, the provider of information about the sale would not conduct the suitability test, but for instance in the EU, he/she has to assess the 'appropriateness' of the financial instrument ('know-the-security' rules), based on the knowledge and expertise of the investor to understand the risks of the transaction.

2.3.2 A regulatory framework for sales practices: The MiFID experience

Investor protection at the point of sale is an important instrument to boost competition in the distribution of financial instruments. The effect of investor protection rules on competition among product providers and distributors, however, is not straightforward and depends on how the rules are devised. The experience in the United Kingdom prior to 2005 illustrates this point well. Advisers could either advise on products across the market ('independent' advice) or represent one company and sell only its products ('tied' advice). The rules were aimed at simplifying the market and clarifying the attribution of responsibilities to reduce misselling. However, competition did not improve much, as investors failed to shop around and compare the products offered by different tied advisers. In 2005, the market was 'depolarised' and the rule that prohibited tied agents from selling third-party products was abolished (FSA, 2002; FSA, 2008). In devising investor protection rules, policy-makers should therefore be mindful of their impact on competition. Furthermore, investor protection in the sale of financial instruments can also impact the distribution of savings across different solutions and even increase the level of participation of retail investors in financial markets, potentially leading to a higher savings rate with wider economic effects on investments and growth.

The EU legislative framework differentiates between advised and non-advised sales. Investment advice is defined by the European MiFID legislation as the provision of a 'personal recommendation', with elements of 'opinion', to a client in respect of one or more transactions in financial instruments (CESR, 2010).[24] When providing such a recommendation, the firm has to ensure that the recommended transaction is suitable for the client, with reference to his or her investment objectives and ability to bear financially the risks involved in the transaction. When no personal recommendation is provided, the firm only needs to ensure that the client has the experience and knowledge to understand the risks in the transaction (appropriateness test). MiFID also provides an opt-out clause from non-advised sales tests for non-complex financial products, such as shares, thereby exempting investment firms from applying any test ('execution-only' clause). This clause relies on the assumption that the simple structuring of some financial products (listed in the Directive) makes them broadly suitable for any retail investor, who can assess himself or herself the suitability of the product on the basis of their own situation.

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[22] For more information about the early development of agency and fiduciary relationships and theories for investment firms, see Lesh (1946, p. 1237).

[23] United States Court of Appeals, District of Columbia Circuit; 174 F.2d 969 (D.C. Cir. 1949).

[24] Art. 4.1.4 Directive 2004/39/EC, Art. 52 Directive 2006/73/EC and CESR/10-293.

Table 5. Overview of the regulatory framework for sale practices in MiFID I

Service	Details	Assessment	Information
Advised sales	Personal recommendation [a]	Suitability	- The recommendation meets the client's investment objectives - The client is able financially to bear the investment risk - The client has the experience and knowledge to understand the risks in the transaction[b]
Non-advised sales	Information collection	Appropriateness	- The client has the experience and knowledge to understand the risks in the transaction [c]
Execution-only sales	Execution	None	- Only for products classified as non-complex by MiFID, if at the initiative of the client who is warned about the risks[d]

[a] For a more detailed definition of advice under MiFID, please see CESR (2010).

[b] Art. 35 Directive 2006/73/EC (implementing MiFID I).

[c]Art. 36 Directive 2006/73/EC (implementing MiFID I).

[d] Art. 19.6 Directive 2004/39/EC (MiFID I), including shares admitted to trading on a regulated market, money market instruments, bonds or other forms of securitised debt (except if they embed a derivative) and UCITS.

The distinction between advised and non-advised sales relies on the definition of 'personal recommendation', i.e. on the ability of the investor and the supervisor to distinguish between information that contains an element of opinion from neutral information that does not exploit any of the several biases that affect investors' decision-making, especially when the relationship between distributor and investors transpires in a bilateral environment with oral agreements. The definition therefore appears weak on several fronts. In effect, the consistency of the current framework (see Table 5) is impaired in practice by:

i) The difficulty for investors to distinguish a personal recommendation from general information, and

ii) The ability of the intermediary to provide a personal recommendation orally without any assessment of suitability and, under poor recoding practices, formally classify the transaction as a non-advised sale or if the product is eligible, as an execution-only service.

There is indeed evidence that intermediaries sometimes evade their responsibilities by inducing confusion in investors about the sale process (ESMA, 2011).

In addition, the directive fails to acknowledge that any assessment of suitability is contingent on the characteristics of the service provided, including the range of instruments considered, the level of expertise and the remuneration of the intermediary. In this sense, a distributor only offering a narrow sample of instruments from a restricted set of product providers will ordinarily be unable to compare costs and other relevant features in the risk-return profile of the investment. Similarly, a distributor with insufficient expertise may not have enough understanding of the products offered to carry a meaningful suitability assessment. And the structure of remuneration may embed incentives to sell products with a higher margin, even if unsuitable for the individual investor. There is abundant evidence of all three of these respects.[25] Most notably, due to is definition, it is possible under EU legislation to consider a piece of advice from a distributor that offers a limited range of financial instruments and comparability as a 'personal recommendation', rather than just pre-sale information, and its compensation is affected by the monetary and non-monetary inducements of the provider.

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[25] See ESMA (2011), AMF (2012), Synovate (2011), FSA (2007), FSA (2010a), FSA (2011a) and De Manuel (2012b).

MIFID I did not address any of these three respects. It attempted to limit the inducements paid by originators to distributors but it did not achieve this partial objective either. The directive prohibits inducements but grants an exemption based on three conditions (Art. 26, Impl. Dir. MiFID I):

i) They are designed to improve the quality of the service to the client;
ii) They do not impair the ability of the firm to comply with its duty to act honestly, fairly and in the best interest of its clients; and
iii) They are appropriately disclosed.

By granting such a wide margin for interpretation to investment firms on a case-by-case basis, the prohibition of inducements is stripped of its meaning,[26] with the result that a large number of firms have not altered their behaviour following the introduction of MiFID.[27] The regulator assumes that there might be unbiased advice even if the distributor receives a commission for suggesting one product rather than another and fails to provide a transparent framework for investors to be able to discriminate among different sale and 'advice' services.[28]

2.3.2.1 The new EU proposal for investment advice

In light of several misselling cases across Europe related to advised sales in particular, the European Commission proposed in 2011 a reform of MiFID that formally introduces a new category of advice, so-called 'independent advice'. This 'independent' advice would need to fulfil two conditions. The advisor must:

i) Assess a sufficiently large number of financial instruments; and
ii) Not receive any monetary benefits from any party other than the investor.[29]

In addition, investment firms would have to inform clients as to whether their advice is provided on an independent basis and whether it is based on a broad or on a more restricted analysis of the market.[30]

The proposal has some merit in acknowledging that not all services falling under the legal definition of investment advice are the same. But it only addresses inducements, and it does not consider the biases created by training and professional standards. In effect, even absent inducements from originators, any distributor may set a remuneration policy for its sales force that may be incompatible with their fiduciary duty towards investors, i.e. by pushing unnecessary sales or portfolio rotations for the investor due to the fees and indirect benefits that these operations generate (so-called 'churning').

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[26] Implementing Directive 2006/73/EC prohibits investment firms from providing or receiving any inducements (monetary or otherwise). However, inducements are allowed if they satisfy three requirements: (Art. 26). This test puts the weight on the individual self-assessment by firms of each inducement on a case-by-case basis (CESR/10-295, p. 18). Implementation at EU level has followed a soft-approach based on interpretative guidelines and a market survey for firms to "benchmark themselves against industry compliance practices" (CESR/10-295, p. 5).

[27] "These requirements have not always proven to be very clear or well articulated for investors and their application has created some practical difficulties and some concerns." – European Commission SEC (2011) 1226 final (impact assessment MiFID 2), p. 16. "CESR [ESMA] acknowledges that the application of the test might not always be straightforward" – ESMA Report, CESR/10-295 (inducements, MiFID), p. 22. "Most of the investment firms sampled said that they assess payments and non-monetary benefits they provide or receive for compliance with the MiFID inducements rules" – ESMA Report, CESR/10-295 (inducements, MiFID), p. 8. Research has shown that a very small number of advisers disclose inducements and other conflicts of interest to clients – Synovate (2011, p. 9). See also AMF (2012).

[28] "For the purposes of the provisions of this Directive concerning inducements, the receipt by an investment firm of a commission in connection with investment advice or general recommendations, in circumstances where the advice or recommendations are not biased as a result of the receipt of commission, should be considered as designed to enhance the quality of the investment advice to the client" (Recital 39, Impl. Dir. MiFID I).

[29] Art. 24.5, Legislative Proposal COM (2011) 656 final (MiFIDII).

[30] Art. 43.3, Legislative Proposal COM (2011) 656 final (MiFIDII).

At the same time, by failing to set minimum entry requirements to the profession, there is little to warrant that advisers and sales staff can cope with growing complexity and innovation in financial instruments.

The proposal also relies on the assumption that investors can understand and price "independent" versus "non-independent" advice. This situation may not create incentives for distributors and third party advisers to describe themselves as 'independent' and to cease receiving inducements, which the impact assessment accompanying the Commission's proposal mentions as a "significant possibility" (European Commission, 2011a, p. 68, 193 and 258).

In effect, the distinction between independent advice and other 'advice' services is not straightforward for investors. For instance in the UK, despite independent advice being more prevalent than elsewhere in Europe, a large proportion of retail investors misunderstand the concept of independent advice. Over 40% of individuals who had recently purchased an investment product or had requested advice failed to label correctly the service received. Even more worryingly, 65% of recent purchasers who had received non-independent advice believed they had contacted an independent financial adviser, known in the UK under the acronym IFA (FSA, 2011a).

2.3.3 Is a new approach to investment advice possible?

The difficulty to apply a *tout court* prohibition of inducements (whether monetary or non-monetary) when providing advice, on top of the complexity to distinguish between 'advised' and 'non-advised' sale (i.e. when a 'personal recommendation' is provided), may call for a net separation between advisory services and pre-sale information services in non-advised sales. This approach to investment advice would keep both distribution channels based on biased (by monetary and non-monetary compensation) and unbiased advice, but with a more coherent separation.

The problems enumerated in the previous sections suggest that the regulatory framework for sale practices, while formally constraining investment firms, may require additional focus. Arguably, a new regime for selling practices should seek to achieve three objectives:

i) Improve the quality of advice by addressing the level expertise, conflicts of interest in remuneration and market coverage;
ii) Clearly separate advised from non-advised sales, reducing confusion for investors; and
iii) Ensure proportionate access to advice, including for low-income and non-urban areas.

Advised sales should be clearly separated from other services. In an occasional oral exchange between the intermediary at the front desk and a small investor, it is relatively easy for an intermediary to give a personal recommendation to a client without assessing suitability first. Monitoring costs would be high as well, as recording conversations is not feasible in the context of face-to-face intermediation and therefore sales agents may classify actual advised sales as non-advised with relative ease. Insufficient awareness among investors as to the process of delivering and receiving advice also facilitates circumvention. Regulation is largely responsible for this confusion since it sets a distorted definition of regulated 'advice' that includes personal recommendations delivered by tied sales agents.

On top of abilities to circumvent suitability requirements, and since face-to-face intermediation is still one of the key distribution channels, investment advice should be more narrowly defined. The current definition of advice rests on false assumptions that the suitability test would ensure that any personal recommendation will be in the best interest of the client (whether or not it is based on inducements) and that no personal recommendation would be given in the context of face-to-face intermediation without first assessing suitability. Those assumptions do not hold in practice; there is sufficient evidence showing that the suitability test is misapplied in practice, resulting in unsuitable recommendations in roughly half the cases, and the intermediaries can easily induce confusion in clients to avoid assessing suitability.[31] Regulation should acknowledge that the results of applying the

[31] See ESMA (2011), AMF (2012), Synovate (2011), FSA (2007), FSA (2010a), FSA (2011a) and De Manuel (2012b).

suitability test are contingent on remuneration practices and market coverage and circumvention of the suitability test can only be mitigated by clearly differentiating advice. No regulatory test can uphold investor interest in the presence of inducements by originators or narrow market coverage. Genuine advice requires both remuneration practices that are free of conflicts of interest and the consideration of a reasonably broad pool of products and providers.

Advised vs. non-advised sales should be separated in a manner that is directly apprehensible by the investor and the distinction 'independent' vs. 'restricted' may not be easy to understand as long as it is considered 'advice' after all and not a tied sale. The denomination of 'investment advice' shall therefore be reserved for personal recommendations where the adviser accepts no (monetary and non-monetary) inducements and considers a reasonably broad range of products and providers vis-à-vis the investment objective of the client. All other sale services should be named 'pre-sale information' services and if personal recommendations are delivered, it should be considered by the client as pre-sale information because it would not be considered (even if proved) as 'advice' by the authorities. It would work in the same way that the authorities obtain sales information from car dealers selling products from a predefined set of (or just one) car manufacturer(s). In effect, with or without a framework for advised sales, the investor will most likely receive a personal recommendation (whether captured or not by the suitability test in the advised sale regime) to buy the product that is offered by the distributor receiving benefits from the product originator. Advice should be recognised up front as a recommendation to buy something that is in the best interest of the client. If it is not in the best interest of the client because it is distorted by side benefits, it should be merely treated as pre-sale information about the product to lure investors in.

This legal demarcation between advised and non-advised sales would most likely boost the creation of a reputational market for pure investment advice. It would be the only way for investors to clearly distinguish advice from informational services, so in the end they can price the service by weighing the cost of a potentially more expensive (lower returns) and unsuitable financial product with the cost of an advised suitable product (with higher returns) plus an advisory fee. Even though it would not solve the underlying adverse selection problem with financial services, it may somehow be a way to signal the risk of moving into a lower quality service and contain the adverse selection (and inability to price quality) that reduces the possibility to find a higher quality (suitable) advice. The investor does not see a 'measurable' reason to pay for it and therefore it is mispriced. Following this separation, even if the investor is still unable to better distinguish between advice and pre-sale information services, there will certainly be more chances for him/her to know the possibility to access advice tailored around his/her best interest.

Table 6. Separating 'investment advice' and 'pre-sale information' services

Pre-sale information		Investment advice
(Monetary and/or non-monetary) Inducements	↔	No inducements
Limited or broad range of products and providers	↔	Broad range of products and providers
Revised appropriateness test	↔	Revised suitability test
Strict professional standards	↔	Strict professional standards
Full cost disclosure	↔	Full cost disclosure

Source: Authors.

The ability to identify advice in the best interest of the client from other forms of biased recommendations may also be a way to promote more responsible investment decisions through, for instance, fiscal advantages by governments for those investors that actually request investment advice. Access to investment advice in the best interest of the client may also promote greater financial education and understanding of investment objectives, as the advisor would set up a tailored path to identify the suitable investment.

Suitability and appropriateness tests would need to be recast to reflect this segregation between regulated 'advice' and 'pre-sale information' services. The revised suitability test would pay specific attention to costs and fees, as a key element determining net returns for the investor and the execution of his or her investment objectives. In so doing, it should ensure that the advisor would pay due attention to comparing the (implicit and explicit) costs among similar products. The revised appropriateness test for pre-sale information services would consider, in addition to the clients' expertise, his or her ability to bear the risk of losses – so as to reduce the scope for gross misselling of risky products to individuals with low income or little wealth.

2.3.3.1 Other requirements for pre-sale and investment advice services

Transparent categorisation and ex-ante disclosure of the conflict of interest may be insufficient to ensure the delivery of pre-sale information services in the best interest of clients. Some limits to inducements should also operate in the case of 'pre-sale information' services. For instance, the cost of distribution (paid today through inducements) shall be fixed at a company level by the distributor, who will charge the same cost to all providers, while access to the distribution network would need to be provided to all originators on fair commercial terms. Deviations from a fixed price, which could also be damaging to the competitive setting if distributors have oligopolistic market power in their specific segment, could be considered if the terms of the premium or discount are disclosed ex ante and applied in the same way to other originators.

Advice should be easily accessible to all individuals in a manner proportionate to their needs, given by their level of income and wealth. Individuals with low and moderate incomes will increasingly need investment advice, in particular to plan for retirement. It is therefore essential that access to advice is fostered irrespective of wealth or geographical location and, as long as advisors meet high-quality professional standards, barriers to entry/exit for advisers are kept at a reasonably low level. The notion of 'proportionate' access recalls, however, that most investors need basic advice, in contrast to the sophisticated services used by more affluent investors. In order to ensure access to advice for low-income investors or those residing in remote geographical locations, universal service obligations could be envisaged to avoid financial exclusion. The concept of 'basic advice' would need to be defined in connection with elements such as the pension system provided in each member state, which may or may not include default or compulsory options.

Remuneration should be aligned with the client's interest, i.e. policies and practices should not set incentives to 'push' certain products or rotate portfolio composition without regard to the client's best interest. The varying level of inducements paid by product originators to distributors is just one example where remuneration is not aligned with client interest. Beyond inducements, however, internal remuneration policies can also work against client interest, for instance by making disproportionate rewards conditional on achieving a specified number of sales.[32] Legislation and supervisory guidelines can address these problems only partially.

The professional standards of individuals selling financial instruments should be raised. Some member states have already imposed minimum entry qualifications and/or ongoing training requirements – notably the UK, Sweden and France. Yet, national rules can be 'circumvented' by 'passporting' services from elsewhere in the EU – since professional qualifications are the competence of the home member state, employees in branches may not always comply with the requirements of the host country.[33] This risk of circumvention, coupled with the lack of action by

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[32] For example, see ESMA 2012/570 Consultation Paper, Guideline on remuneration policies and practices (MiFID).

[33] Under Art. 13 Directive 2004/39/EC (MiFID), organisational requirements are the competence of the home member state, which includes professional qualifications under Art. 5.1.d Directive 2006/73/EC ("to employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them"). For instance, a firm 'passporting' into the UK would not be subject to the FSA's requirements under its

most member states despite evidence of poor knowledge and expertise among agents, certainly calls for minimum requirements to be set at EU level.

2.4 Is best execution the silver bullet?

The general clause, which is common in securities regulation, obliging the investment firm to act in accordance with its clients' best interest establishes a fiduciary duty between the firm and its clients. Building on the common law principles of agency relationship, this fiduciary duty is generally seen as a duty of best execution in the provision of investment services, which obviously falls on the provider. Even though this duty is explicitly stated in common law and US securities regulation, no details existed in US securities regulation on how and when it should be implemented (Macey & O'Hara, 1997). Only with the entry into force of Regulation National Market System (NMS) in 2005, [34] was best execution for equities identified as the law of the best price across different trading platforms (represented by the National Best Bid and Offer), in addition to a prompt execution and on the appropriate venue (Poser & Fanto, 1997). Still, no details are specified in US securities regulation of how and when this duty should be exercised for other asset classes or more specifically for other investment services than reception and transmission of orders.

In contrast, European securities regulation has gone farther in defining the circumstances in which the best execution duty applies, although precisely how the duty should be applied remains controversial (Valiante, 2011). The best execution obligation is complementary to the 'know-your-product' rules, 'know-your-customer' rules and disclosure requirements mentioned in previous sections. MiFID applies the best execution duty to: execution of orders on behalf of clients, reception and transmission of orders in relation to one or more financial instruments and portfolio management. The investment firm would need to take "all reasonable steps" to obtain the best net result for the client, "taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant for the execution of the order" (Art. 21, MiFID I). The scope of the duty is broad, which has raised questions about its actual implementation (Lannoo & Valiante, 2011; Assi & Valiante, 2011). Doubts also remain on the application of the duty for retail investors. In effect, best execution for retail investors is determined by 'price and cost' (Art. 44, Impl. Dir. MiFID I), but "where there is more than one competing venue" the "firm's own commissions and costs for executing the order on each of the eligible execution venues shall be taken into account" (Art. 44.3, Impl. Dir. MiFID I). As commissions or costs of the link to an eligible trading venue are often at discretion of the parties (the broker and the execution venue), this clause may have left space for a less strict implementation of the retail best execution obligation.

2.4.1 Best execution as a narrow 'default rule'

Although investors may have different needs in the execution of the transaction, a broad selection of criteria to meet the best execution duty makes observability and verifiability of best execution more difficult, and so the enforcement of best execution policies too. A restricted definition (like the 'best bid and offer' obligation in the Order Protection Rule of Regulation NMS), though, may reduce choice and concentrate competition only on direct trading costs, i.e. bid-ask spread on order books. An alternative solution would need to protect the investor's choice by balancing discretion and customisation in the drafting of execution policies with a duty that is clearly observable and verifiable.

Training and Competence Sourcebook, which includes holding a relevant qualification and carrying out continuing professional development. Individuals operating in branches established in the UK may be subject, however, to the FSA's Approved Persons Regime, which includes the Customer Controlled Function (CF30) where an individual is carrying out a retail distribution activity. This means that the FSA's Statement of Principles and Code of Practice (APER) would apply to these individuals.

[34] Securities and Exchange Commission, Release No. 34-51808; File No. S7-10-04 (www.sec.gov/rules/final/34-51808.pdf).

On top of access to trading data to assess the execution quality ex post, a balance between monitoring costs and investor choice can be achieved by using a 'narrowed' best execution duty as a 'default rule' for reception and transmission of orders, execution on behalf and portfolio management. The default rule would then leave the parties to agree on a bilateral basis an execution policy that would deviate from the 'default' and would include additional parameters agreed by the parties. The 'narrow' best execution can be defined as the obligation to execute the transaction at the best price available on legally classified trading venues at net of the explicit (fee) and implicit (bid-ask spread) costs that the venue will charge at that moment, calculated on a reasonable time frame (latency may not be necessarily high-frequency). The narrow best execution definition would perhaps capture the vast majority of investors' preferences at execution, while leaving to the bilateral setting more sophisticated execution requirements, which can be used by some specialised professional investors. Bilateral negotiations, however, should not circumvent the default rule by agreeing on execution policies that offer less parameters than the default rule. Whether these additional parameters negotiated bilaterally will be priced in the execution costs, or rather internalised at no additional cost for the investor, would be left to the contractual power that the investor can actually exercise. Bilateral agreements would also leave to the bilateral negotiations the frequency of revision of execution policies.

The implementation of this definition would also require greater comparability between the data produced by different trading venues and the harmonisation of data formats in order to reduce the costs of data and increase accessibility to pre-trade data. Overall, the restricted mandate for execution policies would also improve observability and verifiability, which are minimal informational requirements to define a contractual contingency (Hermalin et al., 2007).

2.5 Complaint resolution and incentives

A comprehensive approach to investor protection also requires a smooth complaint filing and resolution framework, which can boost a more effective private enforcement, especially if dealing with small misselling practices that have high monitoring costs from a centralised infrastructure. Private enforcement over the sale of financial instruments is very limited in Europe today, and only a few countries have a dedicated infrastructure that promotes private enforcement. Despite greater financial integration, therefore, the lack of a European consumer agency still reflects the piecemeal national approach to marketing of financial instruments and to remedies. A common European approach is paramount in the following areas:

1) Complaint filings to national authorities and support into litigation
2) Collective actions
3) Sanctions
4) Redress procedures

Complaints filing is a primary source of private enforcement and allows investors to reach the authority before the litigation begins, opening the door for alternative settlement procedures that reduce costs for investors and increase their incentive to monitor providers. However, it also involves high implementing costs, which requires a dedicated infrastructure that can also provide support to the investors during the litigation. The introduction of collective action tools in several countries has begun to promote private enforcement, but activism is still limited (Civic Consulting, 2008; European Parliament, 2012; European Commission, 2013).

Moreover, regulating the sale of financial instruments requires sanctions with a strong deterrence effect, as profits generated by wrongdoing in the trading or sale of financial instruments can be very high due to the network effects. In addition, in some cases when there is no 'smoking gun', the 'credence good' nature of financial products makes the assessment of damages very complex, thereby discouraging reporting in the first place. In effect, the risk of long and costly court trials for the investor can reduce the incentives for small investors to report misselling practices and other wrongdoings. Private enforcement, therefore, must be complemented with an effective system of sanctions and out-of-court alternative dispute resolution (ADR) that can reduce costs of litigation borne by the investor and the product provider. Sanctions are often small administrative fines. In an environment with high transaction costs to conduct litigation or other ADR (reflected in a higher probability that the wrongdoing remains undetected), punitive damages, such as treble damages, may discourage the use of bad practices on a large scale. However, it can generate wrong incentives, such as excessive litigation and it is less effective in addressing individual wrongdoings. In some extreme cases, criminal sanctions could be a necessary corollary to punitive monetary sanctions. In an environment where the transaction cost for litigation or ADR is low, which is then reflected in a higher probability that the wrongdoing is detected (because for instance the local financial authority has put in place an effective financial ombudsman service), ADR systems might be more effective for the end investor and less costly for every actor involved (European Commission, 2011b). However, if investors' access to private enforcement tools is too cheap, the 'credence good' nature of financial products may increase the probability of unnecessary litigation and also costs for the system. A comprehensive approach would need to balance accessibility to private enforcement with a proper complaint selection mechanism.

2.5.1 What role for investor redress?

Given thus the difficulties to observe and benchmark performance for the individuals themselves and then to report wrongdoing to the authorities, strong private enforcement is needed to ensure compliance. Investors redress refers to the enforcement of investor rights, either by means of injunctive relief (the cessation of an illegal activity) or compensation (the award of damages for harm caused). Redress may arise both from private or public enforcement but is conceptually different from the repression of unlawful behaviour, typically through punitive fines imposed through administrative or criminal proceedings.[35]

The enforceability of rights by investors is central to the effectiveness of any investor protection framework. Indeed, no right is effective unless it can be enforced, by means of accessible, affordable and expedient procedures. Intermediaries would have few incentives to comply with legislation and act in the best interest of investors unless credible enforcement mechanisms would exist. At least four elements configure an effective framework for investor redress: i) a transparent channel for customer complaints, managed internally by the intermediary, ii) an efficient mechanism for out-of-court dispute resolution, iii) access to judicial review and to traditional civil litigation; and iv) effective integration of the former three elements with public enforcement, notably by financial supervisors.

The markets in financial instruments Directive (MiFID) establishes that investment firms should maintain effective and transparent procedures for the reasonable and prompt handling of complaints received from retail clients, and to keep a record of each complaint and the measures taken for its resolution (Art. 10, implementing directive). The effectiveness of internal complaint handling depends on its quality and supervision. Firms should be required to communicate clearly to clients how to file internal complaints and be accountable to minimum standards of reasonable process and handling times. Moreover, they should also provide aggregate information on complaint handling to their supervisor.

Investors would typically need to first file an internal complaint before seeking recourse to any mechanism for out-of-court dispute resolution. MiFID I only 'encourages' Member States to set up redress procedures for the out-of-court settlement of consumer disputes concerning the provision of services by investment firms (Art. 53).[36] However, the proposed revision of MiFID I will require firms to join a scheme for the alternative resolution of consumer disputes, meaning that such schemes

[35] In other words, the objective of redress is the provision of relief directly to the investor, in his or her own interest, rather than punishing the firm. Yet, in some jurisdictions, notably in the US, investor redress can lead to the award of punitive damages in excess of the harm caused – a phenomenon explained, partially at least, by weak public enforcement. EU law rejects punitive damages with the intention of allocating repressive objectives solely to public enforcement and avoiding the potential for double punishment (Commission Recommendation 2013/396/EU).

[36] A strict obligation will be in place from July 2015 in accordance with Directive 2013/11/EU.

will have binding jurisdiction over service providers. It will depend on Member States whether such schemes will be endowed with the power to deliver binding decisions on any of the parties. For example, the decisions of the Financial Ombudsman Service of the United Kingdom are binding on service providers.

The change introduced by MiFID II follows the adoption of Directive 2013/11/EU on alternative dispute resolution (ADR), which creates an obligation for Member States to provide full ADR coverage at EU level, including for financial services, and provides a set of quality criteria regarding the effectiveness, fairness, independence and transparency of ADR. It also obliges firms to inform consumers about ADR. The 2013 ADR Directive covers all non-judicial procedures, such as conciliation, mediation and arbitration, aimed at settling disputes between parties through the intervention of a neutral entity. It is complemented by Regulation 524/2013 on consumer online dispute resolution (ODR) setting up a single online platform for investors to access ADR throughout the EU.[37]

While investors need to have access to judicial review of ADR process, the grounds of review should be limited in order to preserve the integrity and effectiveness of the ADR process. In any event, non-judicial mechanisms should remain as an ‘alternative’ to a fair trial by a court of justice, in line with the Charter of Fundamental Rights (Art. 47).[38] The judicial systems should, in addition, provide a satisfactory channel for collective claims, in order to facilitate access to justice (notably for small claims), achieve procedural economies (in instances of mass harm) and promote fuller enforcement. Recommendation 2013/396/EU on collective redress sets out a number of principles with respect to comparable collective actions in the EU. The choice of legal instrument, however, represents only a first step in this process.

3. Conclusions

Origination, distribution and sale of financial products are complex activities, which create different kinds of market failures, most of which are driven by information asymmetries at each phase of the lifecycle. Investor protection should minimise the negative effects of these failures on the allocation of capital in the economy. Investor protection so far has failed to take a comprehensive approach, focusing instead on general clauses in financial regulation and broader market transparency requirements that disregard how financial products are originated, distributed and sold up through the end of their life span. A comprehensive approach to investor protection, developed around the lifecycle of a financial product, would ensure sufficient protection to investors at each of the four major lifecycle phases (diagrammed in Figure):

1) Structuring (origination and distribution);
2) Marketing (pre-sale);
3) Execution (sale); and
4) Final use (after sale).

Ex ante and ongoing disclosure requirements complement more invasive principles, such as ’know-your-product’, ‘know-your-customer’ and ‘know-the-security’ rules.

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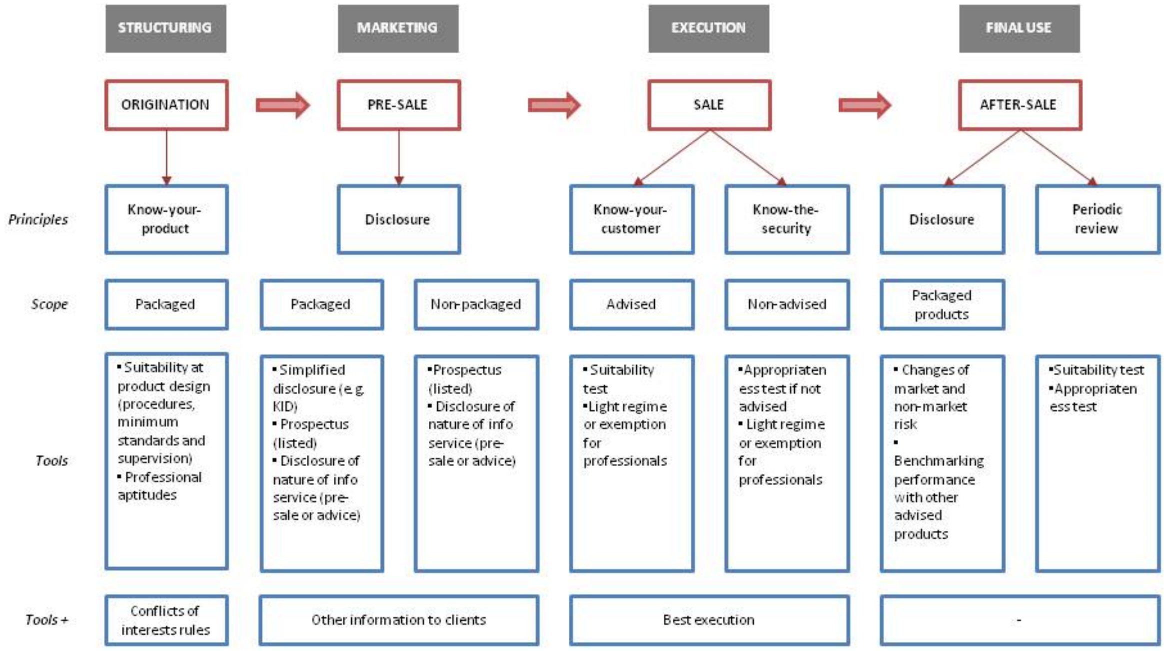
[37] The ADR Directive and ODR Regulation should be effective from July 2015 and will apply to all sales and service contracts.

[38] Arts 10 and 12, among others, of Directive 2013/11/EU protect the right to a fair trial.

Figure 4. Lifecycle approach to investor protection



Source: Authors.

At origination and distribution level, rules shall make sure that the product and its distribution channel are suitable for the class of investors to whom they are offered, without hampering financial innovation by imposing on the originator a particular type of product structuring (such as for UCITS). Before the financial product is actually sold to investors, the transparency of the product shall be simple enough for an average investor to also understand non-market risk, on top of fees and pure market risks.

Moreover, the environment in which the sale of the financial product takes place should be clear to the investor (and the supervisor), in order to avoid behavioural failures (such as the framing effect). However, improving the ability of the investor ex ante to distinguish between advice (a personal recommendation) and pure pre-sale commercial information would not be sufficient and most investors would still suffer framing effects. Hence, a sale of financial instrument should always be considered 'non-advised' (not a personal recommendation) when the sale involves inducements (monetary or non-monetary) or other types of interests from the product originator or from the distributor of the intermediary that sells the financial product tied to the originator. Ex post this would also facilitate the work of supervisors who would be able to identify advised sales more easily, thereby ensuring a more effective application and supervision of the suitability test. No intermediaries selling financial products with a conflict of interest with the provider or a distributor linked to the provider, either with inducements or an ownership stake, should be considered as an advisor and all sales should fall under the appropriateness test. A clear ex ante distinction between pre-sale services and advice would be beneficial to create the right incentive for a market for investment advice to emerge. As discussed earlier, the UK failed in this respect.

In addition, once the product is sold, the investor is often left on his own, while the financial product may even change its original structure. Packaged products may require a minimum level of ongoing disclosure to make sure that fundamental changes to market and non-market risks are fully disclosed to investors, so they can evaluate whether the original conditions that have led them to buy the financial product have changed. For non-packaged products, periodic review of suitability and appropriateness tests for that financial product may be a good complement to ex ante investor protection.

Finally, there are additional tools that can complete this comprehensive approach to investor protection. First, best execution for some execution services remains vaguely defined, while a narrower definition that reflects the vast majority of the transactions in the market could be an effective 'default' rule from which parties can deviate, according to their wishes to be negotiated in their execution policy with the intermediary. Second, the mechanisms of complaint resolution and redress procedures can promote an effective private enforcement mechanism to complement public enforcement, which currently fails in properly supervising a wide range of sale practices from a centralised infrastructure. Sanctions would also need to reflect that 'hit-and-run' misselling strategies, due to network effects, can generate high profits with limited responsibility according to sanctioning systems in several EU member states. A bolder mechanism to make sanctions more effective and harmonised across borders in the EU would greatly complement a life-cycle approach to investor protection in the sale of financial products.

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Annex

Table A1. Selected behavioural biases and suggested policy approaches

Bias	**Concepts**	**Examples**	**Policy approaches**
Procrastination and status quo bias	– Preference to postpone costs even if they would generate higher future benefits – Preference for short-term benefits even if they would generate higher future costs (immediate gratification) – Preference for short-term over long-term gains (hyperbolic discounting) – Reluctance to change and preference for known alternatives (status quo bias)	– Consuming luxury today rather than saving for retirement – Purchasing the first product offered without comparing products and providers – Using a costly credit line to purchase today rather than saving today and purchasing tomorrow – Failing to review portfolio – Invest in the shares of the own employer in a non-diversified portfolio	– Simplify decisions (e.g. standardised disclosure, assistance to decision making and advice) – Committing devices (e.g. automatic enrolment into saving schemes) – Default options – Incentives to save (e.g. tax advantages) – Deterrents to spend (e.g. limits to early withdrawals) – Financial education
Loss aversion and fear of regret	– Individuals will ordinarily put more effort in preventing a loss than achieving a gain (prospect theory) – People demand more for an object than they would be prepared to pay for it (endowment effect) – Reluctance to sell at a loss (risk-seeking effect) – Focus on risks in isolation (myopic loss aversion) – Fear to regret a decision	– Holding onto losing investments and selling winning ones – Anger over a loss of capital tends to be higher than over a loss of returns – Anger over interim losses in long-term investing products – Underinvestment in equity or other products where market risk is present	– Financial education – Simplify decisions (e.g. standardised disclosure, assistance to decision making and advice)
Mental accounting	– Creation of artificial budgets for each sort of expense (known as ‘pots’) – Hedonic editing of mental budgets (creative bookkeeping)	– Borrowing at high-rates while saving at low-rates – Buying luxury despite low savings	– Financial education
Information and choice overload	– Difficulty to process large amounts of information – Inability to identify important information – Large choice increases the likelihood of dissatisfaction	– Inaction when confronted with large choice – Failure to read prospectuses – Failure to shop around – Framing through information overload	– Ease comparability (e.g. summary disclosure) – Restrict choice – Financial education
Overconfidence ~~Confirmatory~~ bias	– Unfounded optimism – Suppression of disconfirming evidence	– Overestimation of future income – Selective focus on information	– Disclosure design – Presentation of alternative scenarios

Sources: Authors’ own elaboration based on De Meza et al (2008) and NEST (2010).

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