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How to Protect Investors

Lessons from the EC and the UK

NIAMH MOLONEY

CAMBRIDGE

HOW TO PROTECT INVESTORS

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CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE UNIVERSITY PRESS
Cambridge, New York, Melbourne, Madrid, Cape Town,
Singapore, São Paulo, Delhi, Dubai, Tokyo

Cambridge University Press
The Edinburgh Building, Cambridge CB2 8RU, UK

Published in the United States of America by Cambridge University Press, New York

www.cambridge.org
Information on this title: www.cambridge.org/9780521888707

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First published 2010

Printed in the United Kingdom at the University Press, Cambridge

A catalog record for this publication is available from the British Library

Library of Congress Cataloging in Publication data
Moloney, Niamh.

How to protect investors : lessons from the EC and the UK / Niamh Moloney.

p. cm.

Includes index.

ISBN 978-0-521-88870-7 (hardback)

1. Investments – Government policy – Great Britain. 2. Investments – Government
policy – European Economic Community countries.

I. Title.

HG4524.M65 2010

332.6094 – dc22 2009038167

ISBN 978-0-521-88870-7 Hardback

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PREFACE AND ACKNOWLEDGMENTS

This book is concerned with the protection of retail or household investors. The retail markets can be something of a Cinderella in financial market regulation. The regulatory challenges can be humdrum but intractable, the retail constituency quiescent and unhelpful to the beleaguered regulator, and the empirical and analytical pyrotechnics of law and finance and of law and economics, typically applied to financial market regulation, often overlook this area; behavioural finance is, however, now taking up some of the empirical heavy lifting. But, as governments withdraw from welfare provision and promote stronger long-term household saving, the retail markets have become of central importance; to borrow a phrase from law and finance, they 'matter'. So does investor protection regulation and how it is developed and designed.

This book accordingly addresses three questions. Who is the retail investor (chapter 1)? Why should that investor be protected (chapter 2)? How should protection be designed (chapters 3–8)? It considers whether investors are best characterized as empowered, irrational or trusting, and considers the implications for regulatory design. Its case study is the massive EC harmonized regulatory regime for Member States' retail investment markets which provides a rich case study of investor protection law 'on the books'. But effective retail market protection depends heavily on 'law in action', which remains largely the preserve of the Member States. The book's main case study for domestic 'law in action' is the UK and, in particular, the retail market activities of the Financial Services Authority.

A note on the European terminology used is necessary. The book is largely concerned with the internal market aspect of the European Union and so generally refers to the European Community, the EC and the EC Treaty. At the time of writing, the Lisbon Treaty had not been ratified by all the Member States. If the Treaty comes into force, the relevant EC Treaty provisions will not change in substance, but will be incorporated into the new Treaty on the Functioning of the European Union, and references to

the EC or European Community in this book should be read as references to the EU or European Union.

This book entered its final stages against the backdrop of the financial crisis. In the maelstrom, as regulatory and governmental attention focused on safety and stabilization, retail investor interests have been largely overshadowed. Household wealth has, however, been destroyed, investor trust has been badly shaken and the policy drive to encourage stronger market-based saving seems quixotic, at least at first glance. Nonetheless, as this book argues, the difficult task of designing an effective investor protection system and of supporting household engagement with the markets must go on. Much greater evidence is needed on how investors think and behave (chapter 2). Hard questions concerning the degree to which investors should be allowed to access more complex products must be answered, particularly given the losses related to structured products over the crisis (chapter 3). Disclosure, the great panacea of modern investor protection, seems all the more a troublesome device (chapter 5). As discussed in chapter 7, the voice of the retail investor, however ill-informed and erratic that voice may be, has been largely absent from the policy debate on the crisis. This must change.

The book aims to state the law and major policy developments as at 31 May 2009 although it has been possible to make some very brief references to subsequent major developments. A number of these are revealing as to the direction of the policy debate on retail investor protection. Most notably, perhaps, the Obama Administration's blueprint for regulatory reform (Department of the Treasury, *Financial Regulatory Reform* (2009)), which took as a key objective the protection of consumers and investors from financial abuse, includes significant institutional reform in the form of a new Consumer Financial Protection Agency which will share responsibility with the Securities and Exchange Commission for protecting consumers of financial services. From an EC perspective, much can be learned from the emphasis being placed on the Agency's gathering of 'actual data about how people make financial decisions.' Otherwise, there is dishearteningly little evidence of any attempts to gather meaningful data on how household investors reacted to the crisis; the European Commission's 2009 Eurobarometer survey on the crisis was limited to a survey of reaction to the EU's general efforts (Standard Eurobarometer (EB 71), *Europeans and the Economic Crisis* (2009)).

Institutional reform has also been a major theme of the EC response to the crisis, although here the retail interest was not the driving factor (chapter 7). The Commission's September 2009 proposals for a European

System of Financial Supervisors and, in particular, for a central European Securities and Markets Authority (which followed the Commission's May 2009 Communication on supervision and the agenda-setting de Larosière Report) promise much for better pan-EC prudential supervision. But the impact on retail market law-making is not yet clear, although the proposed Authority will have the power to adopt binding technical standards (endorsed by the Commission). Some efforts are, however, being made to engage the retail sector with the Authority's work through enhanced consultation procedures (via a Stakeholders Group). The proposed Joint Committee of European Supervisory Authorities may also lead to better cross-sectoral law-making, although institutional segmentation between the banking, insurance/pensions and securities sectors persists in the new model. The initial failure to engage with the retail sector during the important de Larosière discussions remains disheartening (chapter 7). The crisis has, however, galvanized FIN-USE, the EC's forum for the consumer interest in financial services, to produce a number of papers, significant by their very adoption, on the crisis (including FIN-USE, *The Future of Financial Services Supervision* (2009)). Otherwise, and perhaps reassuringly given persistent governance and evidence-gathering weaknesses, there was little in the way of knee-jerk reaction, with the 2009 Commission Communication on the treatment of substitute investment products emerging from a discussion which pre-dated the crisis, although the crisis may have encouraged the Commission to adopt what is a relatively radical reform agenda.

Similarly, in the UK, prudential and stability matters have been to the fore, although the FSA did proceed with the next stage of its massive Retail Distribution Review in June 2009, presenting specific reform proposals designed to address persistent and entrenched conflicts of interest in the commission-based UK investment advice and product distribution industry (Consultation Paper 09/18). The proposals broadly reflect the FSA's final thinking on the Review in 2008 (chapter 4). Investment advice concerning a broad range of substitute 'retail investment products' will be segmented into 'independent advice' and 'restricted advice'. 'Independent advice' must be unbiased, unrestricted and based on a comprehensive and fair analysis of the relevant investment product market. Advice must otherwise be labelled as 'restricted', including where a firm advises only on proprietary products. A new adviser charging model will apply to all investment advice; the current commission-based system will be prohibited. A new professional standards regime for all investment advice will also be adopted.

Overall, however, there is little evidence of a policy concern, post-crisis, to rethink how investor protection is delivered. The dominant assumptions concerning investor empowerment, investor competence and the investor's carrying of market risk remain in place.

The completion of this book was supported by a Research Leave Award from the Arts and Humanities Research Council which I very gratefully acknowledge. Cambridge University Press, in particular Kim Hughes and Daniel Dunlavy, oversaw the book's production with great courtesy and efficiency. I would also like to thank the many people from whose work I have learned; in particular, I owe a great deal to Professors Eilís Ferran, Guido Ferrarini, Klaus Hopt, Howell Jackson, Donald Langevoort, Stephen Weatherill and Eddy Wymeersch, whose scholarship has inspired me.

My greatest inspiration is my wonderful husband, Iain. This book is dedicated to him.

Niamh Moloney
1 October 2009

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ABBREVIATIONS

3L3	three Level 3 Committees (CESR, CEBS and CEIOPS)
ADR	alternative dispute resolution
AFM	Autoriteit Financiële Markten (Dutch regulator)
AMF	Autorité des Marchés Financiers (French regulator)
APCIMS	Association of Private Client Investment Managers
ASIC	Australian Securities and Investments Commission
BaFIN	Bundesanstalt für Finanzdienstleistungsaufsicht (German regulator)
CDO	collateralized debt obligation
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CFD	contract for difference
CIS	collective investment scheme
CNMV	Comisión Nacional del Mercado de Valores (Spanish regulator)
COBS	Conduct of Business Sourcebook
CONSOB	Commissione Nazionale per le Società e la Borsa (Italian regulator)
DMD	Distance Marketing of Financial Services Directive
ECOFIN	Economic and Financial Affairs Council
ECON	European Parliament Committee on Economic and Monetary Affairs
ECOSOC	European Economic and Social Committee
EEA	European Economic Area
EFAMA	European Fund and Asset Management Association
ESC	European Securities Committee
ESME	European Securities Market Expert Group
FESE	Federation of European Securities Exchanges
FIN-NET	Financial Dispute Resolution Network

FIN-USE	Forum of User Experts in the Area of Financial Services
FINRA	Financial Industry Regulatory Authority
FoHF	fund of hedge funds
FOS	Financial Ombudsman Service
FSA	Financial Services Authority (UK regulator)
FSAP	Financial Services Action Plan
FSCG	Financial Services Consumer Group
FSCP	Financial Services Consumer Panel
FSMA	Financial Services and Markets Act 2000
ICMA	International Capital Market Association
ICSA	Institute of Chartered Secretaries and Administrators
IDD	Initial Disclosure Document
IMD	Insurance Mediation Directive
IOSCO	International Organization of Securities Commissions
ISA	Individual Savings Account
ISD	Investment Services Directive
ISDA	International Swaps and Derivatives Association
KFD	Key Features Document
KID	Key Information Document
KII	Key Investor Information
MiFID	Markets in Financial Instruments Directive
MPBR	more-principles-based regulation
MTF	multilateral trading facility
NASD	National Association of Securities Dealers
NAV	net asset value
NURS	Non-UCITS Regulated Scheme
OAM	officially appointed storage mechanism
OECD	Organization for Economic Co-operation and Development
OTC	over the counter
PwC	PricewaterhouseCoopers
RDR	Retail Distribution Review
RSP	retail service provider
SCDD	Services and Costs Disclosure Document
SEC	Securities and Exchange Commission (US regulator)
TCF	Treating Customers Fairly
TER	Total Expense Ratio
UCITS	Undertakings for Collective Investment in Transferable Securities
UCP	Unfair Commercial Practices Directive