

MINISTRY OF FINANCE OF THE CZECH REPUBLIC
RESPONSE TO THE EC CALL FOR EVIDENCE

**„Need for a Coherent Approach to Product Transparency and Distribution Requirements for
„Substitute“ Retail Investment Products?“**

Prague, 17 January 2008

I. General comments and remarks

- We believe that an uneven regulatory landscape at EU level for distribution and provision of services in relation to the broad universe of retail investment products is a problem. In particular, differing conduct of business and information disclosure rules (or, in some cases their complete absence), entail suboptimal investor protection that may thus have a negative impact on the development of the retail financial services markets. Furthermore, the regulatory gap may have been increased following the implementation of MiFID.
- Similar conduct of business rules should apply to as many products offered and marketed on financial markets as possible (i.e. including not only structured products but also “classical” banking and insurance services). This means that the Commission could also consider other financial instruments as well as pension funds, building savings and standard banking deposits in its work on retail investment products.
- However, having a consistent approach to investor protection does not mean that a single-point-of-sale legislative proposal is a desirable solution. For the reasons of a higher legal certainty as well as better transparency of Community law we would prefer a case-by-case approach, considering targeted amendments of “sectoral” directives. Neither do we believe it is desirable to extend the scope of the Commission’s inquiry to the level of product origination.
- We are also of the opinion that a proper response to the above mentioned problems should entail a meaningful legislative element at the EU level. Experience shows that market forces cannot fully tackle investor protection issues as there may be an inherent conflict of interest on the side of the product distributors. On 5 March 2001 an Agreement on a Voluntary Code of Conduct on pre-contractual information for home loans was agreed under the auspices of the European Commission by the representatives of European associations of the credit institutions and the representatives of the European consumer associations. The European Commission issued at the same time a Recommendation 2001/193/EC on pre-contractual information to be given to consumers by lenders offering home loans. However, the Code of Conduct is generally not fully followed by its signatories.
- Finally, we would like to mention the planned timing of the Commission’s work. According to the call for evidence, the Commission only plans to issue a Communication on the subject in the autumn 2008. We understand that the Commission’s commitment to better regulation implies that a certain number of steps be taken prior to deciding on the optimal policy response. This may indeed be quite consuming. However we believe that the seriousness of the problem may call for greater ambition and would welcome if the Communication could be accompanied already by a substantial impact assessment which would indicate future course of action. This would help those Member States currently contemplating their own regulatory response to better plan their activities.

- *some annuities**
 Yes No
- *some bank term deposits (e.g. with embedded optionality or structured deposits)*
 Yes No
- *others ... (please list and describe)*
 Yes No

* **The annuities are considered as a specific insurance product (contracts, other than unit linked contracts, granting regular life time payments).**

What are the features/functionalities (holding period, exposure to financial/other risk, capital protection, diversification) that lead you to regard them as interchangeable? Have you encountered any legal or other definition which would encompass the range of 'substitute investment products'?

Answer

- We believe that more harmonized conduct of business rules should apply to as many products offered on financial markets as possible, i.e. including not only structured or complex products but also “classical” banking and insurance services. This is especially pertinent in light of the current financial crisis emanating from the U.S. subprime mortgage sector. Although trying to draw a parallel between the Czech and the U.S. housing markets would be misleading, the boom in Czech housing prices, the launching of innovative products (e.g. adjustable rate mortgages) as well as aggressive and potentially misleading advertising (“loans with no risks”) are becoming commonplace even in the Czech market. If there are some lessons to be drawn from the recent financial market turmoil, we believe that failure in adequate regulation of mortgage brokers and intermediaries significantly contributed to later adverse developments.
- The Commission could also consider other financial instruments as well as pension funds, building savings¹ and standard banking deposits in its work on retail investment products. Shortly, we believe that the scope of the inquiry as regards the type of investment product should be widened as much as possible.

The approach to all (not only investment) financial products/services regulation in the Czech Republic is – similarly to the EU’s and as stated in this call for evidence on substitute investment products – still largely sectoral. Therefore any legal definition of substitute products is very difficult to find.

Yet, the Ministry of Finance as the regulatory authority responsible for the policy of investor protection on financial market now aspires to follow a more functional approach when designing its new investor-protection regulatory framework (especially in the fields of disclosure and competency requirements imposed on retail products/services distributors).

We agree with the European Commission that „sectoral regulation“ may lead to a regulatory arbitrage, misselling and inadequate level (volume and quality) of information investors get when buying some financial product.

¹ Buildings savings is financial product based on the participation of clients in the creation of joint resources, which can be employed to grant loans with advantageous interest rates for housing acquisition, housing reconstruction and, in general, for meeting the housing needs of clients. Each client saves for a period of time (at least 24 months by law - Act. No. 96/1993 Coll. Act on Buildings Savings with State Assistance) with a possible state subsidy and, after fulfilling set conditions, can be granted a buildings savings loan.

Thus the ministry intends to introduce its own definition of category of **investment and savings products**, describing these generally as **financial products offering the possibility of increasing the value of the investors’ assets, including some form of insurance products meeting the same aim**. According to our opinion the broader approach to the definition of „investment products“, including savings products as well, is necessary for this purpose.

However, setting rules – especially in the area of information disclosure or competency requirements for distributors - may require different treatment. For general requirements there may be used the broad definition, whereas for some specific requirements a more detailed classification will be essential (basic savings products vs. investments in stocks or derivatives).

Question 4: Which factors in your opinion drive the promotion and sales of particular investment products? Please use the table below to rank these factors in terms of importance (very significant; significant; no opinion; insignificant) for each of the different products. In addition to completing the table, we would welcome further explanation of your view as to which factors are particularly important for each product.

Answer *

*We suggest adding also stocks, bonds, pension funds, building saving and standard banking deposits to the substitute products group (see the table below – subcolumns within the column “Others”). The annuities are considered as a specific insurance product (contracts, other than unit linked contracts, granting regular life time payments). The pension funds are considered as a specific product based on the insurance against the financial needs of the old-age people, subvented by the state (on the basis of the Act. No. 42/1994 Coll. State-Contributory Supplementary Pension Insurance Act)

	UCITS	Non-harmonized funds	Unit-linked life insurance products	Retail structured products	Annuities	(Structured) Term deposits	Others			
							Bank deposits	Stocks, bonds	Pension funds	Building savings
Taxation	S	S	VS	S	VS	I	I	S	VS	S
Financial innovation	I	S	S	S	S	I	I	I	S	I
Cultural preferences	S	S	S	S	S	I	S	S	I	S
Distribution models	S	S	VS	S	VS	I	I	S	S	VS
Regulatory treatment	S	S	S	I	S	I	I	S	S	I
Others - state benefit	n/a*	n/a*	n/a*	n/a*	n/a*	n/a*	n/a*	n/a*	VS	VS

* not applicable

Question 5: Product disclosures: Do pre-contractual product disclosures provide enough information to help investors understand the cost and possible outcomes of the proposed investment? Please use the attached tables to provide your evaluation of the adequacy of the information provided with regard to the following items for each category of investment product.

Answer *

*We suggest adding also (1) stocks, bonds, pension funds, building saving and standard banking deposits to the substitute products group (see the table below – subcolumns within the column “Others”) and (2) other categories of product disclosures (see the table below – rows from “Financial services/product distributor to “Guarantee schemes”) that we see as significant.

The annuities are considered as a specific insurance product (contracts, other than unit linked contracts, granting regular life time payments). The pension funds are considered as a specific product based on the insurance against the financial needs of the old-age people, subvented by the state (on the basis of the Act. No. 42/1994 Coll. State-Contributory Supplementary Pension Insurance Act)

Nature of information provided	UCITS	Non-harmonized funds	Unit-linked life insurance products	Retail structured products*	Annuities	(Structured) term deposits**	Others			
							Bank deposits***	Stocks, bonds	Pension funds	Building savings***
Product features	Yes	Yes	No	Yes	No	Yes	Yes	Yes	Yes	No
Direct costs	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Indirect costs (or foregone performance)	Yes	Yes	No	Yes	No	No	No	Yes	No	No
Risks	Yes	Yes	No	Yes	No	Yes	Yes	Yes	Yes	No
Capital guarantee	Yes	Yes	No	Yes	No	Yes	Yes	Yes	Yes	Yes
Likely performance	Yes	Yes	No	Yes	No	Yes	Yes	Yes	Yes	No
Conflicts of interest	Yes	Yes	No	Yes	No	No	No	Yes	No	No
Compensation or fee retrocession	Yes	Yes	Partially	Yes	Partially	No	No	Yes	No	No
Financial service/product distributor	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No
Possible changes in the contract	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Partially	No

Nature of information provided	UCITS	Non-harmonized funds	Unit-linked life insurance products	Retail structured products*	Annuities	(Structured) term deposits**	Others			
							Bank deposits***	Stocks, bonds	Pension funds	Building savings***
Consequences of contract commitments breach	Yes	Yes	No	Yes	No	Yes	Yes	Yes	Yes	No
Where and how to get information (when necessary)	Yes	Yes	Partially	Yes	Partially	Yes	Yes	Yes	Yes	No
Complaints and disputes resolution	No	No	Yes	No	Yes	Yes	Yes	No	Yes	No
Taxes	Yes	Yes	Partially	Yes	Partially	No	No	Yes	No	No
Guarantee schemes	Yes	Yes	No	Yes	No	Yes	Yes	Yes	No	Yes

* At present as well as after the MiFID implementation

** Relevant regulation is to be found either in acts or in general terms and conditions issued by financial institutions and in their rules of conduct

As far as term deposits are concerned, the providers are not obliged to provide any pre-contractual product disclosures offered in the tables in particular. The Banking Act only requires that a bank provides information on deposit acceptance conditions and mandatory deposit insurance and settles that this information must be provided in business premises of a bank in writing. Code of conduct between banks and their clients issued by the Czech Banking Association as a self-regulation instrument includes a provision, that clients should get basic information on conditions, price and risks related to a product. This Code of conduct is generally not fully followed by its signatories.

*** Relevant regulation is to be found in acts and in general trade terms issued by building savings banks

When assessing the level and quality of pre-contractual disclosures, it is necessary to distinguish

(a) **the existence of disclosure requirements (incorporated into legislative or non-legislative acts and rules of conduct) – that is what we assess in the table above** - from

(b) their real fulfilment in relations between financial service/product distributors and investors and from

(c) the investor effective understanding of the information.

The regulation of disclosure should be assessed in several aspects. Analyzing the requirements, mainly the following questions should be answered:

- 1) Are there any requirements for the pre-contractual disclosure? What are they?
- 2) Are the requirements set down by law or any code of conduct? Is there an effective enforcement of fulfilment of the code of conduct?
- 3) Do the requirements apply to each type of investment product?
- 4) Do the requirements apply to each type of financial service/product distributor (both for financial institution employees and financial intermediaries)?
- 5) Do the requirements apply to each type of distribution channel?
- 6) Do the requirements set down the form in which the information should be disclosed (in written/oral form, with the specification of fonts and formats, etc.)?
- 7) Do the requirements distinguish the information provision (information disclosed automatically) from making the information available (information on request)?

In the MoF's opinion, most problems in contemporary (not only) investment products information disclosure follow from

- a) a imbalance between the level of disclosure regulation across the sectors offering investment products (capital market, insurance market and market for saving products)
- b) an insufficient regulation of the form the information is presented (disclosed) to consumer (compared to the regulation of its content) – e.g. there is almost no prescribed format of documents the consumer should receive (e.g. like so called „product list“- including the basic information of product in transparent, simple and complete way - or the mandatory rules for designing layouts of terms & conditions, etc.)
- c) different disclosure liabilities set down for different types of financial service/product distributors (employees vs. intermediaries in case of insurance products/services) and distribution channels (distance marketing vs. sells in customer´s presence)
- d) a possible investor´s information overload resulting from requirements to disclose information automatically; however, there may be some information that could be available just on request (needed to be specified).
- e) an inadequate level of investor´s financial literacy – investors receive information but cannot use it when making financial decisions.

In the insurance sector, the Czech Republic is facing a gradual change in distribution. **Compared to previous years, intermediation has gained greater influence.** As a consequence, the level of commissions has risen considerably. In our view, this rise has gone beyond standard economic competition, especially in retail products. Thus, we deem it necessary to draw European Commission´s attention to this problem and would support any initiative aiming at market consolidation or greater transparency (e.g. in line with the inducements provisions introduced by MiFID)

As a general approach for possible harmonization of the rules for substitute products we recommend to set a „disclosure basis“(categories of information investor should receive) common for all investment products/services and to define a set of requirements for specific product groups (subgroups). That seems to be necessary because - despite the similarities - there are significant features that are specific to the individual types of investment/savings products.

Question 6: Conduct of business rules: *Do differences in conduct of business regulation result in tangible differences in the level of care that different types of intermediary (bank, insurance broker, investment advisor/firm) offer to their clients? For which conduct of business rules (know-your customer, suitability, information/risk warnings) are differences the most pronounced and most likely to result in investor detriment?*

Answer

The regulation of conduct of business rules is considered to be most adequate and advanced in the field of securities. Concerning financial instruments (non-harmonised funds and most of retail structured products), an advantage is that, apart from UCITS funds, subjects other than MiFID firms are not allowed to distribute these products. Thus, no valid differences arise. Furthermore, whole MiFID regime for the distribution seems to be well calibrated.

As to other products, we see two deficiencies. First, it is the fact that some of these products can be channelled via different distribution channels with different conduct-of-business rules applying. Second, even if, they can be channelled via a single channel or via different channels (however, with same or similar regimes of the rules of conduct), such rules are not so robust and detailed like the conduct of business obligations imposed by MiFID.

Most significant risks for investors arise from inadequate risk warnings concerning a given product as well from misleading information concerning the expected performance of unit-linked insurance products, including misinformation on the consequences of early termination of the insurance contract. According to the § 21 par. 8 of Act No. 38/2004 Coll. on Insurance Intermediaries and on Independent Loss Adjusters and on amendment to the Trade Licensing Act (Act on Insurance Intermediaries and Loss Adjusters), insurance intermediaries have the commitment to record client's needs and requirements concerning the negotiated insurance product and reasons that lead the intermediary to propose certain insurance product to him. Yet, these requirements are ordained for the intermediaries only, not for insurance companies and their employees, which can negatively affect the level of investor protection.

Concerning the banking instruments there are no legal conduct-of-business rules. The code of conduct between banks and their clients issued by the Czech Banking Association, as a self-regulation instrument, sets only vague consultation rights to clients; it is not specified in relation to the particular conduct of business rules.

Question 7: Conflicts of interest: *Are there effective rules in place to ensure effective management/disclosure of conflicts of interest (and/or compensation arrangements) by the different categories of product originators and/or intermediaries for the different types of investment product? For which type of product do you see a regulatory gap in terms of the coverage of conflict of interest rules? Please explain.*

Answer

One has to be careful and distinguish between management/disclosure of conflicts of interest by the product originator (the issuer) and product distributor.

As regards disclosure of the conflicts of interest by the product originator by the different categories of capital market products, information on conflicts of interest is included in the prospectuses for transferable securities and UCITS, which are harmonised documents. In the Czech Republic, furthermore, such information is contained in the prospectuses for non-harmonised funds.

As regards disclosure of the conflicts of interest by the product distributor we think that this issue is well solved by the MiFID. By the different categories of non-capital market products (as by life insurance products²), conflicts of interest should be regulated in the same way as by the MiFID.

We do not see any need to extend EU harmonisation towards originators of other products. This should be left on Member States.

Question 8: unfair marketing / misleading advertising: *Is the risk of unfair marketing / misleading advertising more pronounced for some product types than for others? If so, why? Can you point to concrete examples of the mis-selling of the different types of investment product resulting from unfair marketing / misleading advertising?"*

Answer

² According to the § 21 of the Act No. 38/2004 Coll. on Insurance Intermediaries and on Independent Loss Adjusters and on amendment to the Trade Licensing Act (Act on Insurance Intermediaries and Loss Adjusters), client must be - on his request - given the information of the methods of the insurance intermediary remuneration. Yet, this requirement can be effective and prevent conflicts of interests (between incentives given from insurance company to intermediaries and consumers needs) only if the client knows his rights and if the information given to him is adequately specific.

The problem of unfair marketing / misleading advertising (that is prohibited by the Czech law) can be indicated especially in the case of long-run products like investment life insurance products where client is not entitled to be given the information about main risks and possible consequences associated with them – especially about the uncertain performance of the portfolio, costs and fees of the insurance contract, consequences of cancelling it, etc.

In most cases it takes clients some time to realise what the substance of a chosen financial products is long time after the conclusion of the contract. Unfortunately for them, the result usually falls short of their original expectations. According to the Czech law, there is a three-year-term within which it is possible to impose sanctions to an advertiser for the reasons of misleading advertising. This term is very short in comparison with one of the main characteristic features of these long-run savings products – the presumed length of the contract. Furthermore, a person who orders an advertisement is required to keep a copy (a trailer) of such an advertisement for a period of 12 months.

However, experience shows that advertising is difficult to regulate and supervise.

Question 9: *Is a horizontal approach to product disclosures and/or to regulation of sale and distribution appropriate and proportionate to address the problems that you have identified? Can you specify how this objective of coherence between different frameworks would address the problems? What are the potential drawbacks of such an approach?*

Answer

Yes, we believe that a horizontal policy approach to determine disclosure rules as well as conditions for distribution is an appropriate solution in this area. However, as explained in the general introduction, having a consistent approach to investor protection does not mean that a single-point-of-sale legislative proposal is a desirable solution. It is already quite difficult to find the correct boundaries between, e.g. MiFID and UCITS directives. Thus adding a new kind of regulation that would operate besides existing directives or even overlap with them could be potentially of concern. This is why we would prefer, where possible, targeted amendments of “sectoral” directives which would spread useful and ‘transferable’ regulatory tools from fields where those tools have proven to be successful to other fields while taking account of sectoral specificities. Furthermore, this new kind of regulation would also contain provisions applicable to other financial products that have not been regulated by sectoral directives yet. Finally, we prefer to govern this area under the maximum harmonization rule.

Question 10: *Can market forces solve the problems that you identified (fully/partially)? Are there examples of successful self-regulatory initiatives in respect of investment disclosures or point of sale regulations? Are there any constraints to their effectiveness and/or enforceability? Are you aware of effective national approaches to tackle the issues identified in this call for evidence? Should it be left to national authorities to determine the best approach to tackling this problem in their jurisdiction? Is there a case for EU level involvement? Please explain.*

Answer

Due to increasing market integration and in view of the fact that obligation to provide certain pre-contractual and contractual information about a variety of financial products as well as the conduct-of-business rules for financial services providers are currently regulated by EC law, it is clear, that the necessary steps are to be taken at the European level. No other solution could be sufficiently effective and efficient. While self- / co- regulation has its place in the market, we believe that sole

reliance on self regulation will not be sufficient to tackle the problem at hand. This is especially the case for a market where significant conflicts of interest and informational asymmetries exist.

The main constraint for an effective self- or co-regulation is the optionality and non-binding nature of self-regulatory recommendations or rules. There is no efficient enforcement of fulfilment of the codes of conduct (some of them are published as „standards“ with a rather informative or recommending character).