



# **REPORT**

on the marketing of financial products

Presented by

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## **EXECUTIVE SUMMARY**

This report examines ways and means to improve conditions for the marketing of savings products.

1) The **reasons for action** are based in large part on the need to meet a growing demand for information and advice by consumers on savings investments, notably for the purpose of retirement as well as preventing a recurrence of incidents of misselling.

The occurrence of such incidents in France, though on a less important scale than in other countries, particularly in 1999-2000, resulted from a failure to provide suitable information on products (selling on the basis of the most recent past performances, advertising concealing or minimizing the risk of loss, excessive focus on the liquidity of products that provide a return only if held for a significant period) as well as marketing practices at odds with the role of providing investment advice (advertising campaigns focusing exclusively on the sale of a product, frequently insufficiently targeted and without sufficient analysis of the financial situation, the needs, investment horizon and risk profile of the investor). Measures have been undertaken in several establishments to remedy these practices and their broader application should be encouraged.

In contrast, the transformation of financial systems and product offerings (banking disintermediation, development of unit-linked life insurance products) has contributed to a transfer of risk and responsibility to retail investors. This latter trend will only increase as new approaches to prepare for retirement develop (individual or collective defined-contribution savings plans partially replacing public and company defined-benefit schemes).

This increased demand for information and advice from financial intermediaries is taken into account in the recent European directives on insurance mediation and markets in financial instruments and by Anglo-Saxon financial regulators.

This report emphasizes that these requirements should be equally applied to all savings products (direct investments in equities, UCITS mutual funds, units or shares in real estate companies or life insurance policies), all types of producers and distributors (members of salaried networks or independent distributors) and all distribution channels (face-to-face or distance-selling) to prevent or remedy competitive distortions.

2) To respond to these requirements, **recommendations** are proposed focusing on the six major objectives

The first is to provide **more pertinent information on products**.

Firstly, pre-contractual information (the simplified prospectus for UCITS and prospectus for life insurance contracts) must be simplified and focus on **six key areas** to enable consumers make informed investment decisions:

- the nature of the product (in stocks, bonds, money market, etc. for UCITS; individual or group with annuity or lump sum payments for insurance policies);
- the existence of an unconditional guarantee providing for the recovery of invested capital or not;

- a suggested minimum investment period which must take precedence over liquidity for all risk products, as statistics demonstrate that the risk/reward ratio of investments, notably for equities, is much more favorable when this period is longer;
- an evaluation of the prospects of gain and risks of losses over this period, on the basis of at least two opposing market performance models;
- total fees for which the report proposes using a composite indicator of their impact on the return provided by the product over the recommended investment period;
- the target investor profile: in this respect, the report recommends that the products involving the greatest risk and complexity and for which the risks of misselling would be greater if marketed to retail investors be limited to qualified investors both in France and at the European level.

The **advertising** of products must be systematically monitored to ensure that it is correct, clear and not misleading and provides a balanced presentation of the advantages and risks of the product in line with its characteristics.

Finally, promoters of products financed through loans must indicate the minimum return needed from this type of investment to cover the fees (including the loan interest).

The second objective is to **ensure better retail network target marketing of savings products**. Based on the best practices identified in establishments evaluated in the course of the Review, the report recommends more refined customer segmentation, greater differentiation of product ranges and establishing a tiered salesforce organization to adapt, according to the relevant training and experience, the skills of sales advisors to products they are authorized to sell. For this purpose, a training record should be maintained for each sales advisor indicating training received and the experience acquired in the sale of these products.

The third objective is to **provide customers with advice adapted to their needs and profile**.

In this respect, the report clearly defines the scope of the obligation to provide advice associated with a sale resulting from either a direct solicitation of the customer by the seller or in response to a request for advice by the customer. This is distinguished from an order placed by the customer, generally transmitted by phone or another form of electronic transmission, without involving a request for advice, where the service provider intervenes on an execution-only basis in accordance with the directive on markets in financial instruments (MiFID).

The report also determines minimum due diligence required by the seller in connection with an advised sale, in respect to the know-your-customer obligations and efforts to propose suitable products adapted to the customer's objectives, investment horizon and risk profile.

To facilitate these objectives, the report recommends that establishments provide sales advisors with advisory support resources. The purpose of these resources should be to assist sales advisors overcome their reticence about offering capital risk products to customers, particularly equity-based investments when they respond to customers' needs, as well as to make advisory services available to a wider retail customer base at costs that are not prohibitive.

Finally, in compliance with European directives, the report recommends that records of advisory services provided be maintained, storing the customer relationship file and recommendations in a computer customer record, to enable compliance controls of advisory services and provide supporting documents in the event of claims.

The fourth objective **is to safeguard the objectivity and impartiality of advice** that can be skewed by distributor compensation methods. To avoid this risk, it is recommended that:

- for integrated networks, establishments ensure the maximum degree of neutrality in systems of variable compensation and review the activity of the salesforce in respect to a given product.
- for independent distributors of the producer, the latter discloses to its supervisory authority every year commission rates paid the previous year for products to its different distributors to enable this authority to identify and sanction cases where distribution agreements grant preferential treatment to given products not in the consumer's interest and that could impair the neutrality of recommendations provided by the sales advisor. For imported products, the same obligation shall apply to the distributor.

To promote a more neutral system for the remuneration of advisory services in the form of fees paid by customers, it is proposed that these fees be deducted from taxable investment income.

The fifth objective is to **promote greater responsibility by all parties involved in marketing financial products**:

- by clarifying the respective duties of the producer and distributor. The first should be responsible for designing and profiling the product, documents and contractual and pre-contractual information and ensuring that advertising faithfully reflects the product characteristics. The second should have exclusive responsibility for transmitting the information and advice to the customer.
- by granting financial investment advisors the possibility of adopting the status of broker or agent acting on behalf of the customer rather than as a direct marketing agent of the producer.
- finally, by teaching buyers of financial products to ask the right questions to advisors/salespersons by promoting certain concepts including notably the importance of the suggested minimum investment period. To this purpose, customers should be provided with information on product performance based on annualized year-on-year results over this investment period rather than annual results over a number of years.

The sixth and last objective is to **improve after-sales service**:

- on the one hand by remaining vigilant concerning the conditions according to which a product or contract is modified in the course of its lifespan;
- on the other hand, by facilitating out-of-court settlement of disputes by a centralized department to handle complaints in each establishment supplemented by a right to mediation.

3) To implement these recommendations, the report proposes, in addition to a limited number of legislative and regulatory measures, the adoption of conduct of business rules to be developed by associations representing the professions concerned and subject, at their initiative, to approval by public authorities, rather than imposing them through regulations. The latter method should be adopted only if these rules are not developed within a one-year period.

The enforcement of these rules shall be ensured by compliance monitoring procedures implemented by credit institutions and investment companies and internal control procedures of insurance companies, supplemented by external controls of their respective regulatory authorities (AMF, CCAMIP, Banking Commission).

For the latter two authorities it is proposed to:

- harmonize the powers for exercising controls, injunctions and sanctions, extending to the CCAMIP (*Commission de Contrôle des Assurances, Mutuelles et Institutions de Prévoyance*) the authority granted to the French securities regulator or AMF (*Autorité des Marchés Financiers*) and the Banking Commission to sanction violations of conduct of business rules;
- strengthen cooperation between the different authorities notably by conducting joint controls and coordinated studies on subjects of common interest;
- extend to the CCAMIP and the Banking Commission the authority already granted to the AMF to formulate recommendations and instructions concerning the interpretation of laws and regulations they are responsible for applying;
- provide for improved representation of financial product consumers by creating a consumer panel within the framework of the French advisory committee on the financial sector (CCSF or *Comité Consultatif du Secteur Financier*).

This report consequently proposes the creation of a true **financial product marketing charter** for professionals and consumers.

## **INTRODUCTION**

Following past practices of misselling financial products and in order to establish a status of financial investment advisor and transpose various European directives, the French Minister of the Economy, Finance and Industry, in a letter dated April 6, 2005, asked us to examine ways “to prevent risks of misselling and develop a uniform and coherent organization for the marketing” of savings products (see appendix I).

1) Under the terms of this letter, **this Review is to focus** on the marketing of financial products to **retail investors**, thus excluding investments proposed to institutional investors that involve a different set of issues.

The notion of marketing is not defined in either French or European Community laws and regulations. However, it may be understood to imply an active undertaking by distributors to sell one or more products, whether through direct marketing (cold calling) or within the framework of investment advisory services provided by a bank branch, insurance intermediary, or financial investment advisor, or through a web site. As such it is distinguished from orders to purchase or subscribe for investment products initiated directly by the customer and carried out by the intermediary on an execution-only basis.

Sale and purchase orders, however, are both based on **product information** that the producer is responsible for providing. This information must be sufficiently pertinent, clear and comprehensible for the investor to make an informed decision.

The sale also involves an additional feature of providing **advice**. This requires certain efforts on the part of the distributor in fulfilling know-your-customer obligations and identifying products meeting the customer’s needs, risk profile and investment horizon. In this respect, misselling may consist both of selling a high-risk or speculative product to an investor seeking security as well as selling a safe but low-yield investment to an investor willing to assume risks to achieve the highest possible return.

This Review will consequently focus on these two themes of providing information and advice.

Although it covered all savings products, this Review has focused more on “financial” **savings products** (primarily UCITS and life insurance but also equity investments in the primary market, shares in real estate undertakings and structured products) than “bank” savings products (savings accounts and savings plans with banking institutions), which are easier to understand for retail investors.

2) Accordingly, within this specific framework, our work carried out between April and October 2005 has drawn upon contributions from:

- a **working group** consisting of representatives of the General Directorate of the Treasury and Economic Policy or DGTPE (*Direction Générale du Trésor et de la Politique Économique*), the French advisory committee on the financial sector or CCSF (*Comité Consultatif du Secteur Financier*) and the three independent French authorities responsible for regulation and oversight in this sector. These are the AMF, the insurance regulator or CCAMIP and the Banking Commission. This working group met 11 times, drawing upon the analysis and input from these different authorities (see appendix II).
- a series of **meetings** (see appendix III):



- 14 meetings with financial service companies (six retail banks, three insurance companies, five independent companies), supplemented by these establishments' responses to several detailed questionnaires;
- meetings with six industry associations, four consumer associations and a specialized attorney.

3) The results from these efforts are presented in this report, which is divided into three sections.

The first section provides an overview presenting the reasons for action to improve conditions for the marketing of financial products.

The reasons are based as much, if not more so, on the need to respond to increased consumer demand for information and advice on savings investments, especially in preparation for retirement, as on preventing incidents of misselling whose causes nevertheless need to be analyzed to ensure that such practices do not reoccur.

The second part presents **recommendations** resulting from the study and consultations conducted by the Review.

These recommendations concern the pertinence of information provided on financial products, the quality of advice given to the customer (which requires better targeting of marketing initiatives), clarification of the respective responsibilities of producers, distributors and consumers in these areas and improved after-sales service.

The third section analyzes **ways to implement** these recommendations.

These methods less involve the introduction of a limited number of regulatory and legislative reforms than the application of best practices identified or recommended by the Review in the form of conduct of business rules that may be approved or recognized by public authorities and whose application should be subject to both internal compliance monitoring by the establishment and external controls by the regulators.

## **I.**

### **REASONS FOR ACTION**

The mission conferred upon us was considered necessary for four major reasons:

- an increased need for information and advice associated with the transfer of risk and responsibility to retail investors in a financial system marked by increasing disintermediation;
- a need to prevent the recurrence of incidents of misselling of the recent past (involving both abusive marketing practices and simply the sale of products not adapted to the customer's profile or needs);
- requirements resulting from European regulation and measures undertaken by other regulators in this area;
- risks of competitive distortions between products, market participants and distribution channels that may have an impact on the marketing of financial products.

#### **1.1. A growing need for information and advice in response to the transfer of risk and responsibility to retail investors and the trend of disintermediation**

This need is the result of two major trends in our financial system transferring an increasing share of both the risk and the responsibility of choosing investments to consumers.

##### ***1.1.1. Banking disintermediation and the transfer of risk for life insurance***

In the past, credit and market risks were primarily assumed by banks and insurance companies. Today, retail investors incur a larger share of this risk. This trend, which began more than 25 years ago, has been driven by two developments (see appendix IV).

The first is **an increase in total household savings of the share of financial savings invested in securities, UCITS shares or life insurance policies** in relation to savings accounts or savings plans with banking institutions. Accordingly, from 1990 to 2003, the share of "bank" savings in total household financial assets (excluding unlisted securities and other participating interests) declined more than 10 points from 53.3% to 42.5%.

The second is the **development of unit-linked insurance policies** or products as a percentage of total life insurance investments in relation to traditional life insurance policies or products. In contrast to the latter, where the risk is born by the insurer, the first are subject to the sole provision of the existence of minimum guarantees, most frequently granted in the event of death, at the risk of the insured. Mathematical reserves for unit-linked products as a percentage of total life insurance reserves has risen from 10% in 1994 to 18% in 2003, after a peak of 22% in 2000. While new investments declined between 2000 and 2003 in response to the stock market crash, the upward trend resumed in 2004.

### ***1.1.2. Changes relating to preparations for retirement***

This transfer of risk and responsibility will be accentuated in the future by new mechanisms introduced to prepare for retirement.

Largely in response to the aging of the population, this trend in France (as was the case in the United Kingdom) should be characterized by a partial but increasing shift away from public and company defined-benefit plans to **individual or group defined-contribution savings plans**.

In the latter systems, as with direct or indirect investments in financial market instruments, the risk and responsibility of choice is passed on to the consumer. This responsibility is only further increased when the investment horizon is longer.

The challenge for the retail investor is choosing between investment return and security. To ensure that costs for additional retirement benefits are not prohibitive, achieving an adequate investment return must be a priority. However, such a return within this horizon requires a sizable initial investment in equities. On the other hand, security becomes increasingly important as one approaches retirement age. Even if the design of certain regulated retirement products (such as the PERP or *Plan d'Epargne Retraite Populaire*) facilitates this choice, the range available to investors among the different products, and for a single product between different formulas (life annuities, pure endowment, point-based pension schemes) and type of unit (euro, euro-diversified, units of account), is very large.

### ***1.1.3. Increased need for information and advice from financial intermediaries***

In response to these trends, consumers can only make proper choices if provided with adequate information and advice.

They must consequently be given information that is clear, fair and not misleading about the principal characteristics, advantages and disadvantages of products that may meet their needs.

The **advice** to be provided must moreover be **adapted to their needs**. This ideally implies:

- **an as accurate as possible assessment** of their situation, objectives, investment horizon and risk tolerance profile;
- **appropriate advice for the allocation of their assets**, enabling them at every stage of their life to adjust by asset category the allocation of their savings in a manner that best fits their needs and investment capacity;
- the most **objective advice** possible concerning the **choice of products**, presenting for each category of assets the best prospects for a return after fees in relation to the given level of risk.

This demand for information and advice quite naturally concerns financial intermediaries, whether banks, insurance undertakings or asset management advisors. These professionals must be able to respond with impartiality in a manner adapted to each customer.

## 1.2. Lessons from past incidents of misselling

Most large countries in the development of their financial market economy have experienced in the recent past problems of misselling (ranging from recourse to abusive marketing practices to the sale of unsuitable products in relation to the customer's profile or needs). To avoid a recurrence of these practices with potentially adverse consequences for investors, financial institutions and the financial system as a whole, their causes should be analyzed.

### 1.2.1. Failure to provide adequate information on products

Incidents of misselling in the recent past have resulted from errors in pre-contractual information<sup>1</sup> and advertising concerning financial products.

The most prevalent have concerned promoting sales **by invoking the most recent past performances of the product** (or, in the cases of new products, their underlying market). This practice reinforces investors' natural pro-cyclical tendency that frequently incites them to buy high and sell low, disregarding the golden rule for investing in financial markets. This behavior has been particularly pronounced both in equity markets and shares or units in real estate companies (see appendix V).

This problem is further compounded by **advertising that overly emphasizes potential gains while concealing or minimizing the risk of loss**, which can lead consumers into error. In this way, investors were led to consider structured capital-at-risk products (SCARP) in the United Kingdom or so-called "*fonds à promesse*"<sup>2</sup> in France as guaranteed investments that in fact only offer protection against limited market declines.

Furthermore, information provided in advertising and sometimes contractual and pre-contractual disclosures on products as a lure to attract investor frequently **emphasized the liquidity of products that in reality offered a satisfactory risk return ratio only if held for a sufficiently long period**. In this way, life insurance policies are frequently presented as offering liquidity at any time. Regulation requires them to publish their "redemption" price at the end of each of the first eight years of the policy even though the minimum period to fully benefit from their tax benefits is eight years.

This problem is further exacerbated by two defects related to the design of the products themselves.

Firstly, **a growing share of these investments is increasingly risky and/or complex**. Low interest rates tends to increase the leverage effect on which their return depends but also the risk, not only in the case of hedge funds in the alternative management segment but also for "coordinated" UCITS investment funds marketed to the retail market, as the UCITS directive amended in 2004 considerably increased the possibility of using derivatives. Furthermore, these structured funds rely on performance indicators based on index baskets or values of variable geometry in terms of duration, increasingly esoteric and difficult to understand for the average investor and even the seller.

Secondly, **new products are frequently insufficiently targeted**. While regulation requires designers of UCITS investment funds to define the target investor profile, in most cases this profile is limited to a summary of the UCITS investment strategy, without even indicating if destined for qualified investors or the general public. This clearly does not contribute to proper selling practices.

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<sup>1</sup> Pre-contractual information is information to be provided before the signature of a contract or the subscription application of the product and may possess contractual value as well.

<sup>2</sup> Today referred to as "*fonds à formule*" in France.

**1.2.2. Conflicts between marketing practices and the function of providing advice**

One of the most noteworthy causes of misselling in the recent past has been **marketing based on product push campaigns** destined to place the product with the maximum number of customers without particular concern as to whether the product meets specific needs.

These campaigns have sometimes been **insufficiently targeted**. This results in proposing products to persons for which they were not designed. In addition, sales frequently are not accompanied by even a minimum evaluation of the financial situation, objectives, investment horizon and risk profile of the buyer. This failing is exacerbated by the fact that sellers, sometimes themselves insufficiently informed, have strong incentives to sell the maximum number of products, whether from commissions based on volume or through staff performance-based compensation linked to achieving ambitious quantitative targets.

**The combination of these factors has contributed to misselling.** Accordingly, regulatory authority mediation services have seen cases of elderly persons and/or persons of modest income seeking secure investments in the year 2000, in some cases pending the completion of a real estate project, who were encouraged to invest a significant percentage or even all of their precautionary savings in “strong growth” unit-linked insurance products consequently involving significant risk, or in structured funds (*fonds à promesses*) presented as safe and non-volatile while in fact offering only partial protection against market downturns. During the same period, there were also cases of amounts originating from a home savings plan (PEL) or a retirement savings plan (PEP) having reached maturity destined for the purchase of a home or, even worse, spousal support payments allocated to a divorced woman receiving only the minimum guaranteed income allowance who needed these funds to meet her expenses until finding unemployment that were invested in equity savings plans (PEA).

Without reaching such extremes, certain practices of sales campaigns focused on products still widely employed in distribution networks **resulted in the provision of inappropriate tax advice in connection with the recent launch of a new French retirement plan (PERP)**. Whereas the tax benefits of this product at the time of the initial investment only apply to persons in high income tax brackets, sales figures received from the French tax authorities indicated that, in 2004, **18% of those who subscribed to the PERP retirement product were not even subject to income tax**.

**1.2.3. Ambiguity in the role of distribution channels**

In contrast to the Anglo-Saxon model, **financial products in France are largely distributed through integrated networks**. These are primarily bank networks but also include insurance networks. The percentage sold through independent distributors is still marginal (see appendix IV).

This distribution organization has both advantages and disadvantages.

**Advantages** include the fact that retail banks with branch networks maintain comprehensive and long-term relations with their customers, ranging from account-keeping to investment services in addition to credit, and are naturally well-placed to satisfy know-your-customer standards and offer the right products. Given that services provided by retail banks in France are overall of higher quality than those offered in many other countries, this favorable position in part explains, despite some notable exceptions, why misselling was less prevalent in France than, for example, in the United Kingdom in the 1990s (the other reason being, it is true, the lower exposure of French households through pension funds to equity market risks).

This positive positioning, shared to a lesser extent by the more specialized insurance company networks, is nevertheless **offset by two factors**:

- Increasing recourse by households<sup>3</sup> to multibanking, resulting in the spreading of their assets. This imposes on the main bank (and *a fortiori* the secondary banks) an obligation to obtain information on assets of their customers held with other establishments to formulate appropriate advice based on an analysis of their total assets, which is not always the case.
- Turnover of personnel in branch offices, particularly high among centralized retail bank networks that may adversely affect the continuity of the customer relationship, especially if records are not maintained in the bank archives.

Furthermore, the bank or insurance branch of an integrated network may be faced with **conflicts of interest concerning the choice of products proposed to customers**.

On the other hand, **different capital adequacy requirements** imposed by regulation may encourage the establishment to promote the sale of one product over another. This is particularly the case for insurers subject to a solvency ratio of only 1% for unit-linked life contracts versus 4% for traditional life insurance policies.

On the other hand, integrated networks for a given class of assets have a **tendency to propose in priority -- and in some cases on an exclusive basis -- proprietary products** that offer margins for their management, life insurance or front office subsidiaries.<sup>4</sup> In practice, this trend – clearly evident with regard to customers whose only alternative is to “go shopping elsewhere” – is admitted except for high net worth clients of private banks or asset managers who are offered a wider range of products from the competition or, at the level of portfolio management companies, by the development of multi-management solutions relying on outside managers for certain classes of assets.

Conversely, **open architecture distribution** by distributors distinct from the producers – whether asset management advisors with the status of financial investment advisors, service platforms or websites offering direct access – theoretically offer a double advantage:

1) The first, more specifically linked to financial investment advisors, is facilitating access to asset management and asset allocation services both comprehensive and, in this respect, independent.

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<sup>3</sup> The TNS SOFRES/Fidelity study of September 2005 indicated that 79% of retail investors surveyed had investments in several establishments. For retail investors with financial assets of more than €150,000, this percentage increased to 86%.

<sup>4</sup> According to the Sofres-Fidelity study, 51% of persons surveyed (covering a selection of UCITS portfolios of more than €7,500) consider that establishments sought above all to sell their product(s) without paying attention to the situation and expectations of the client. This figure increased to 58% for portfolios of more than €150,000.

2) The second, common to all distribution channels distinct from producers, is the ability to provide a larger choice of products in each class of assets that is giving investors more chances to access products offering the best ratio of quality to price.

Concerning this latter point, the theoretical advantage offered by external distribution channels<sup>5</sup> must be put into perspective. In France as in other countries, **compensation of the distributor continues to be largely assured by sharing commissions received by the producer**. This may under certain circumstances result in providing skewed advice concerning the choice of products. This is all the more the case in France, where the financial advisor is able to carry out a sale only as a direct marketing agent of one or more producers.

Until independent advisors can be largely compensated as such by the customer, which should be encouraged but will take time, it is necessary to ensure that each of these distribution methods develops in a manner that guarantees a level competitive playing field.

#### ***1.2.4 Adverse consequences for consumers, establishments and the financial system as a whole***

Regardless of the causes, misselling can have lasting negative consequences for consumers, establishments and the financial system as a whole.

In addition to the losses they may have caused, these practices, if repeated, could **dissuade consumers for some time from investing in assets appearing to represent a short-term risk**, especially in equities. This in turn would contribute to a less favorable allocation of capital, not only in terms of the economy but also in terms of the interests of investors to invest more in this class of assets to prepare for their retirement over a long period.

Misselling also involves **a broad range of risks for establishments**, including harm to their reputations and litigation and financial consequences that will only increase as measures to defend consumer rights gain momentum, even if liability suits in France have not attained the dimensions seen in the United States.

Finally, misselling presents **risks for the financial system as a whole**. By accentuating the pro-cyclical behavior of households in allocating assets between different markets (equities, bonds and real estate), selling based on the most recent past performances could amplify upward and downward fluctuations and undermine the market's financial stability. Furthermore, an increase in or simply the persistence of the practice of misselling could provoke investor aversion to market and credit risks being transferred to households. This in turn would trigger a reversal of the process of banking disintermediation (calling into question the transfer of risk to life insurance through unit-linked products), resulting in the well-known disadvantages in terms of concentration of risks.

Fortunately, these stakes have been understood by European authorities and the regulatory authorities of those countries constituting important reserves of potential savings and the financial establishments themselves.

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<sup>5</sup> It should be noted that the prevalence of non-integrated distribution channels did not prevent the phenomenon of misselling in the United Kingdom or in the United States, where the practice of soft commissions may have impaired the objectivity of advisors in the choice of investment products.

### **1.3. EC requirements and international competitiveness**

The conditions for marketing financial products in France are subject to the need to comply both with European regulations and, to ensure the competitiveness of our financial markets, the highest international standards. Both these requirements involve strengthening obligations of providing information and advice for the sale of financial products.

#### ***1.3.1. Reinforced obligations under European directives to provide information and advice***

The scope of these expanded obligations is notable both for life insurance and other financial products.

##### *1.3.1.1. The life insurance sector*

To ensure that the consumer is “provided with whatever information is necessary to enable him/her to choose the contract best suited to his/her needs,” the third life insurance directive of 1992, consolidated by the 2002 directive concerning direct life insurance, indicated in a detailed list in appendix III point A the information to be provided to the policyholder prior to the conclusion of the contract. These **pre-contractual disclosure requirements** were adopted by the French insurance code with compliance ensured by the CCAMIP.

The insurance mediation directive, currently being transposed, has in turn significantly strengthened **obligations to provide guidance** by insurance intermediaries, whether brokers, general agents or independent agents. In effect, it requires that they provide policyholders a document on a durable medium that “shall at least specify, in particular on the basis of information provided by the customer, the demands and the needs of that customer as well as the underlying reasons for any advice given to the customer on a given insurance product.”

This directive also requires insurance intermediaries to indicate if their recommendations are based on a fair analysis of the products offered on the market or if they work on an exclusive basis with one or more insurance undertakings. This provision considerably strengthens the obligation to provide information and advice that until then was less precisely defined by case law.

##### *1.3.1.2. In the sector of financial products*

**In the case of UCITS**, while the directive covering these products establishes specific guidelines concerning their investment policy and contractual and pre-contractual disclosure obligations (especially through the “simplified prospectus”), and while article 4 of the same directive stipulates that an authorization issued by the home Member State of the UCITS shall be valid for all other Member States, **article 44 specifies that a UCITS which markets its units in another Member State must comply with the laws, regulations and administrative provisions in force in that State in respect to marketing and advertising**, which do not fall within the field governed by this Directive.

In accordance with this principle, the general regulation of the AMF imposes upon persons marketing UCITS units in France a double obligation, also imposed upon portfolio management companies, to inform themselves on the situation and objective of the customer and propose the appropriate product on this basis.



This obligation has been strengthened and extended to other financial instruments by the directive on markets for financial instruments (MiFID) which specifies in article 19 paragraph 4 that “[w]hen providing investment advice [...] the investment firm shall obtain the necessary information regarding the client’s or potential client’s [...] financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the [...] financial instruments that are suitable for him.” In this way the obligation of providing advice includes a double obligation of obtaining knowledge of the customer and identifying the suitable product.

**It makes sense to apply these principles to define the provisions that should apply to the sale of financial products to the extent that such a sale results from advice given by an investment establishment, whether at the latter’s initiative or at the request of the customer.**

While French regulation has already largely incorporated these principles, more precise rules of conduct need to be defined.<sup>6</sup> These should comply with the measures provided for by level two of the directive on markets for financial instruments, currently under discussion. In the meantime, they may draw upon standards studied by the Committee of European Securities Regulators<sup>7</sup> in 2002 to develop these guidelines. The standards are in effect more precise than those provided by French regulation, particularly in respect to:

- maintaining internal records of compliance with “know-your-customer” obligations;
- providing for procedures to formally document refusals by the customer to provide information required or heed risk warnings issued by the service provider;
- the obligation to update changes in the customer profile.

### ***1.3.2. Initiatives by UK and US regulators concerning the marketing of financial products***

Given France's potential as an attractive reserve of savings and its objective of safeguarding the consumer interests, an examination of measures adopted by regulators of other large countries to prevent or sanction misselling may offer valuable insight.

#### ***1.3.2.1. Professional rules developed by UK financial regulators***

Incidents of misselling in the United Kingdom were much greater in number and more important in scope than in France. In response to this situation, much more specific rules were developed in the FSA Conduct of Business Rules handbook, chiefly covering four areas.

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<sup>6</sup> This need for precise and clear rules of conduct governing marketing has been expressed by professionals met with in the course of the Review.

<sup>7</sup> Known in French as “CERVM.”

- **Oversight of the qualifications of sellers**

The service provider must take reasonable measures to ensure that its representatives possess the expertise necessary to sell and provide advice for each type of product and may, if not the case, restrict their authority to sell certain products or require them to refer the customer to a more qualified representative. The service provider must take all measures to ensure that the method of compensation of its representatives or sellers does not impair their neutrality or create an incentive to provide unsuitable recommendations. Finally, the service provider is required to inform the customer of the degree of independence of its advisory services (totally independent or limited to certain products of the group or group partners).

- **Know-your-customer obligations**

The service provider is required to maintain records of information on the customer profile obtained at the beginning of the relationship and during periods that vary according to the products and to update this information on a regular basis or every time advice is provided if on an occasional basis.

A guide for collecting information on the profile of the customer defines the *modus operandi* for service providers. The customer file must include at the very least a questionnaire concerning the customer's needs and priorities and level of risk tolerance/aversion. A hard copy or electronic form of the customer file should be maintained so that it can be easily consulted. The service provider may provide the customer with a copy of his or her "customer profile" information sheet in compliance with the recommendations of the FSA Conduct of Business Rules handbook.

- **Identifying suitable products**

The service provider must make reasonable efforts to ensure that the advice or the transaction are suitable in relation to the information provided by the customer and the product offering of the service provider or group marketing the products.

Specifically, for UCITS, the customer's investment objectives must be regularly reviewed and at least once a year a review is undertaken with the customer to determine if the investment should be pursued or reallocated.

- **Oversight of advertising**

Service providers are to take reasonable measures to ensure that information provided to a customer is clear, fair and not misleading. Service providers are also to record and maintain copies of documents or promotional materials as well as the identity of persons who approved the compliance of these documents.

Accordingly, the handbook for investment service providers established by the FSA promotes the security of marketing actions by limiting conflicts of interest and improving transparency and the quality of advice. This undertaking was completed on the one hand by the opening up of the system for the distribution of financial products and on the other hand by actively sanctioning improper practices. Accordingly, in 2004 the FSA conducted six on-site investigations of distribution networks.

*1.3.2.2 Initiatives by the US regulator against abusive practices*

US regulations today do not offer the degree of detail of those adopted by UK regulators. However, the US has been successful in implementing regulations governing marketing, notably concerning oversight and sanctions against unfair commercial practices.

The know-your-customer obligation and the obligation to propose suitable products constitute an integral part of the rules and regulations governing US financial service providers.

- **Know-your-customer obligations**

This obligation is imposed by NASD conduct rule 2310. Under this rule, prior to recommending an investment to a non-institutional customer, the service provider shall make reasonable efforts to obtain information about the financial profile of its customer, investment objectives and any other information considered useful.

A similar obligation of due diligence is imposed by NYSE rule 405.

- **The role of internal control procedures in verifying the suitability of financial products (SEC Final Rule of February 5, 2004)**

Ensuring the compliance of the portfolio with customer investment objectives and with the information provided by the service provider to the customer constitutes an integral part of the responsibilities of the compliance officer.

- **Conserving copies of documents to verify the quality of the customer relationship retrospectively**

“Investment advisors” must maintain records of information received and provided, including advertising and their investment recommendation (SEC rule 204-2).

Broker-dealers must maintain a record of certain information on each customer (marital status, asset profile, investment objectives). The SEC requires them to communicate with the customer on a periodic basis to update this record.

- **Sanctions against preferential distribution agreements**

The distribution model in the United States, much closer to an open architecture model than the French system, creates a significant risk of skewing investment recommendations in favor of products for which the distributor receives preferential compensation. The SEC applied heavy sanctions against this practice of unfairly promoting certain products by a series of decisions in 2004.

#### **1.4. Unfair competition between products, investment service providers and distribution channels**

The final reason that improvements in regulations governing financial products are needed are inequalities generating competitive distortions between products, market participants and distribution channels. These inequalities could encourage the marketing of unregulated products by market participants not subject to the same constraints as investment service providers or financial investment advisors and by distribution channels subject to less stringent oversight and controls.

##### ***1.4.1. Inequalities between products***

**The ability of regulators to exercise control over marketing varies significantly depending on the financial products involved.** While they exercise full authority for products subject to their authorization, including French UCITS investment funds, their authority is weaker or even nonexistent for products not requiring their authorization.

**The regulator may reserve the marketing of uncoordinated UCITS** to qualified investors and/or investors financially capable of assuming the risks as they

did for ARIA (*Agrées à Règles d'Investissement Allégées*) or contractual funds. In the case of foreign open-end funds, it may even prohibit their distribution in France.

As for **coordinated UCITS** meeting the conditions of the European directive, while their authorization by another Member State is sufficient to give them access to the French market, the French regulator maintains authority for defining the rules for marketing and advertising in compliance with the provisions of article 44 of the MiFID already cited.

Provisions applicable to other products, especially structured products and closed-end funds, have significantly evolved in a manner that has considerably reduced the authorities of the regulator.

**Up until July 1, 2005**, these products fell under provisions for mutual recognition and a prospectus requiring authorizations in both the home and the host Member States. The French regulator was able to subject its authorization to compliance with the “general principles governing warrants and complicated debt securities” concerning the status of the issuer, the liquidity of the underlying qualifying assets and price references allowed, in order to provide a minimum protection for investors.

**As of July 1, 2005**, under the prospectus directive, issuers with their headquarters in one Member State may offer their products to investors in France when authorized by the home state regulator (principle of the single European passport), subject to the simple requirement of notifying the AMF.

Under this provision, the French regulator is no longer able to require that the marketing of these products complies with certain conditions, and notably the general principles mentioned above. At best it may initiate exchanges with the regulator of the country of origin when for example the latter has only examined the general program of the issue and not the memorandum of the product being offered. Investor protection consequently depends entirely on the thoroughness of the Member State of origin’s regulator in examining the conditions of the issue, which unfortunately is not always the case.

When the initial marketing operation involves **a public offering in France** (whether through a public issue or a sale involving advertising), direct marketing or initiatives through credit establishments or investment service providers, or by listing securities on a French regulated market, the AMF may still exercise supervisory authority over the marketing documents.<sup>8</sup> This is not the case, however, when the **product is listed on a regulated market in another Member State** and proposed to investors through indirect channels such as a UCITS or units of account in life insurance policies. Because insurers (legally the owners of unit-linked products) and UCITS investment funds have the status of institutional investors, the products in question do not fall under the scope of a public offering and the AMF is not even notified of their distribution to French investors. As a result, it cannot exercise oversight over these products.

Accordingly, a French producer whose complex and high-risk investment products packaged as a UCITS fund, subject to marketing restrictions by the AMF, was able to avoid oversight by the regulator by adopting another legal form and repackaging it as an identical structured product involving the same degree of risk and complexity within the framework of a unit-linked insurance product issued and listed by its subsidiary in another Member State. However, this listing clearly was not accompanied by the creation of a true market for the product and its sole purpose was to circumvent rules governing the marketing of financial products in France.

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<sup>8</sup> Refer to article 212-28 of the AMF General Regulation (RGAMF).

This situation is clearly not acceptable and requires implementation of national and Community measures to be addressed in the second part of this report.

Another cause of the unequal playing field between products are **differing conditions for the oversight and control over marketing documents** for “financial products” and “insurance products.”

In effect, while the AMF can exercise pre-publication control over all marketing documents for financial products falling under the scope of its authority, this is not the case for the CCAMIP, the French insurance regulator. As a result, the latter does not have the ability to exercise pre-publication control over advertising and contractual documents involving insurance products. The only restriction provided for by the life insurance directive is compliance with “any rules governing the form and content of such advertising adopted in the interest of the general good” (article 47).

In addition, while investment service providers are subject to the obligation to issue risk warnings for complex products purchased directly, this same obligation does not apply to insurers for such products included in unit-linked policies if not excluded by regulation.

#### ***1.4.2. The uneven playing field between market participants***

Several competitive distortions also exist between the different sellers of financial products. Not only does this disadvantage those subject to more precise restrictions, but also in certain cases it reduces consumer protections with respect to the marketing of financial products.

Accordingly, **the obligation of providing advice in the field of life insurance today is not equally applicable to different distributors**. In effect, the insurance mediation directive excludes employees of insurance companies from its scope of obligation. The obligation provided for in this area for intermediaries (general agents, brokers, independent agents) does not apply to insurance undertakings distributing their products through a network of salaried employees. The latter are subject to much less restrictive obligations established by case law to provide the necessary documentation, clear and precise information on the guarantees, etc.

In addition, **financial products can also be marketed by parties not subject to the authority of either the AMF, the Banking Commission or the French insurance regulator (CCAMIP)**. This is the case for regulated professions such as French notaries (*notaires*), lawyers, chartered accountants or real estate agents that may distribute financial products as a peripheral activity. The latter are not subject to obligations of providing information and advice creating a competitive distortion, particularly in comparison with the constraints imposed upon financial investment advisors.

#### ***1.4.3. Potential competitive distortions between distribution channels***

EC directives governing obligations to provide information and advice apply to **face-to-face selling**. However, the development of **Internet platforms** and online marketing creates a risk that these obligations may be circumvented.

While the electronic commerce directive and the distance marketing of consumer financial services directive do not explicitly deal with this risk, they nevertheless do not exclude the obligation to provide information and advice for face-to-face selling.

In effect, the electronic commerce directive, even if it provides for the application of country of origin laws, still maintains certain rights of the host country and recognizes that obligations under directives governing financial products and services continue to apply. Article 11 of this directive moreover specifies that its application is “without prejudice to the level of protection for, in particular, [...] consumer interests, as established by Community acts” explicitly including MiFID, among others.

As for the distance marketing of consumer financial services directive, transposed by ordinance 2005-648 of June 6, 2005, it defines only specific provisions, chiefly concerning prior information to be provided to the consumer and the right of withdrawal, which are added to existing regulations that continue to apply and which do not conflict with its provisions.

Generally speaking, **a hierarchy should be established for EC regulation in compliance with** the principle whereby “special laws create exceptions from general laws.” The directives on electronic commerce and distance marketing of consumer financial services do not establish exemptions to the application of the complementary provisions of the UCITS, MiFID, life insurance and insurance mediation directives. The obligations to offer information and advice provided for by these latter directives should consequently be applicable for distance marketing.

The risk of circumventing obligations to provide advice and information is above all practical in nature and concerns the **difficulty that Host State national regulators will face in ensuring compliance and sanctioning possible violations.**

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In light of the growing need for information and advice by retail investors as they assume an increasing share of market risk, lessons learned from past incidents of misselling, strengthening Community requirements measures implemented in Anglo-Saxon countries, and finally competitive distortions in marketing, improvements must be made in procedures governing the marketing of financial products.

Such an undertaking is clearly necessary to prevent a resurgence of misselling, reassure households in making their investment choices and, finally, contribute to the security of distributors of financial products themselves.

## **II.**

### **RECOMMENDATIONS**

The vast majority of financial institutions interviewed by this Review are sensitive today to the risk of financial product misselling. A number of these firms have taken steps or implemented procedures designed to prevent this risk and to improve the sales conditions for these products.

In this context, the priority has been to determine the best practices developed by one or more firms in each segment that might be used to establish professional conduct of business rules for the industries concerned.

The Review has also identified regulatory changes that should be made by the public authorities involved in financial industry supervision.

This investigation has led to the formulation of a series of recommendations focused on six key objectives

#### **2.1. Improving product information**

The first step to improving financial product marketing is to provide more relevant product information to investors, which can help direct their choices and the sales advisory process. To this end, pre-contractual information should be simplified to emphasize key factors essential for decision-making. This information streamlining should also be coupled with enhanced oversight of marketing documents.

##### ***2.1.1. Simplifying pre-contractual information through emphasis on key factors in consumer investment decision-making***

The material given to investors must be designed to help them make fully informed investment choices. This can be achieved by centering pre-contractual information on the key factors needed to reach a decision.

##### ***2.1.1.1. Better differentiating pre-contractual and contractual information***

Financial product information exists in two forms:

- **Pre-contractual:** The objective here must be to inform and assist the consumer in making an educated investment choice. The material necessary to make this choice must be presented prior to contract signing or investment purchase. This is true even if the information itself has contractual value, such as a simplified prospectus for an investment fund.
- **Contractual:** Of necessity longer and more detailed, this must contain all provisions applicable during the term or holding period for a contract or investment. This includes the terms and conditions for a life

insurance contract, or the full prospectus, rules and charter for a UCITS.

Although pre-contractual information must cohere with the contractual documents, the focus should be more limited and confined to those product or contract features essential for consumer decision-making. In this sense, the pre-contractual information must act as a “how-to guide” for financial products.

#### *2.1.1.2. Identifying key decision-making criteria*

To enable pre-contractual information to fulfill this role for all financial products, this Review has recognized six items corresponding to key questions that investors ask or should ask. These items could be rounded out by additional information as needed, although this should be limited to maintain the document as a compact summary.

### **1) Product type**

Product type must be specified:

- UCITS must state their **primary investment focus** (stocks, bonds, money market, diversified with description of risk profile, etc.).
- Life insurance contracts must indicate:
  - a) whether coverage is **individual or group** (including “open contract”). Note that only individual contracts guarantee that terms will not be changed without the insured’s consent, while group contracts can be modified through simple agreement between the insurer and master policyholder, regardless of the insured’s interests.
  - b) withdrawal methods (annuity payments, cash distribution).

### **2) Capital protection**

The customer needs to know unequivocally if the capital invested will be returned at the end of the investment period after deduction of load fees. The guarantee must be **unconditional** and non-contingent on market performance assumptions. Life insurance products should also state whether capital is protected to contract term, ideally along with other non-cancelable guarantees from the insurer.

### **3) Suggested minimum investment period**

All financial products should indicate the minimum holding period needed to obtain maximum benefit at least risk from the investment (including any applicable tax advantages). This information is crucial. The consumer must be shown that for certain asset classes, particularly the most risky such as stocks, **the risk/reward ratio becomes much more favorable the longer an investment is held**, as demonstrated by all the statistical data examined during this Review (see appendix VI). This information is also necessary to offset the negative impact from financial product advertising that sometimes overemphasizes liquidity (see 1.2.), leading to poor investment choices by investors, including from the tax standpoint.

### **4) Investment risk profile**

The potential for gains or risk of losses for each financial product over a defined period, as shown by performance models, should enable the consumer to make an investment decision without unduly focusing on the most recent past



performance or the risk profile (see. 2.1.2.).

## **5) Typical investor profile**

EU directives now require pre-contractual information for financial products (excluding life insurance) to specify the investor profile suitable for a given product. It is important that producers refine these investor profiles in order to improve target marketing (see 2.1.3.).

## **6) Fees and expenses**

Lastly, pre-contractual information must show load fees and all other expenses charged. These fees and expenses are critical for the investor as they impact product returns by reducing invested capital (load fees) or performance (total fund expenses).

A **summary table of this impact** should be provided if possible.<sup>9</sup> This can be done on a multi-yearly basis, by adding load fees and annual expenses over the suggested minimum investment period. However, to facilitate comparison between funds with different durations, it is preferable to cumulate annual expenses and amortize the load fee over the suggested holding period.

### *2.1.1.3. Presenting these key features*

The primary consumer decision-making information must be presented in readable and summarized form through an identifiable document. It is important that this document be as simple and clear as possible and capable of gradually replacing the advertising materials that too often drive investor choices.

## **1) Financial products (excluding life insurance)**

For UCITS,<sup>10</sup> the EU directive specifies that the simplified prospectus may be used for fund marketing. In this event, the document contains the pre-contractual information.

Although the key features identified above are not explicitly listed in the Commission's April 2004 simplified prospectus recommendation (itself precision for Appendix 1 of the UCITS directive), they do not seem to conflict with the spirit of the recommendation. Furthermore, by helping investors make better informed choices, this information would serve as a selling point for investment funds.

It therefore would be **advisable that the six key features be included among suggested modifications** to the UCITS regime in the framework of the Commission's green paper consultations. This information should figure prominently in pre-contractual documents required from all European Community producers.

The simplified prospectus now presents the six key features discussed above on the same level as a myriad of other less important items for the decision-making process. This content is required by the Directive and consequently cannot be excluded.

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<sup>9</sup> With open architecture it is difficult to determine load fees in advance as these are subject to negotiation

<sup>10</sup> Other products only require an informational document as per the Prospectus directive.

Nevertheless, the AMF recently decided to authorize testing of a **free-form prospectus** that allows producers to highlight key features on one side of a sheet or standard brochure and regulatory information on the other. **The trial run should be reviewed** by 2006, in association with the investment community, once all the simplified prospectuses have been generated. This effort to reorder information by importance, along with the necessary regulatory changes (see 3.1.2), should help clarify the presentation of the existing simplified prospectus.

## **2) Life insurance contracts**

The same simplification and streamlining should be applied to the **life insurance prospectus**. Key features could be presented in a compact brochure that would be more readable than the mass of standard policy provisions. Alternatively, this information might be printed on a contract cover page that may be detachable. There is no legal obstacle to offering an informational document separate from the contract, which would be far more accessible for insureds.

Prospectus contents should be precisely defined and restricted through regulatory law that references the key features previously discussed. Although the prospectus should not conflict with the contract in any way, it should not restate all of the policy provisions.

In order to safeguard the sales process, the customer's **statement confirming reception** of the simplified prospectus or other informational document should be **provided in writing** (rather than printed in the text) on the application that is signed following the sale.

To enable UCITS<sup>11</sup> investors to evaluate the simplified prospectus when presented at time of sale, a waiting period of perhaps two days might be accorded before an application is effective. Investors could waive this right if they want immediate execution of their purchase orders. It is proposed that a working group of investment firms be formed to examine the feasibility of this suggestion.

### **2.1.2 Improving risk-return modeling**

For almost all investment products, consumer expectations for gains or losses are now based on only two items:

- **indicated risk profile**, which is generally qualitative and, at best, measured using criteria and scales that vary among different financial institutions;
- most recent **past performance** statistics.

An exclusive focus on the risk profile overlooks a product's performance or anticipated return. Recent past performance also has two distinct disadvantages:

- not applicable for new products;
- further incites consumers, who hardly need incentives, into pro-cyclical buying counter to their interests.

It would thus be **preferable to include performance models (positive and**

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<sup>11</sup> Life insurance buyers already benefit from a 30-day no-penalty cancellation period following the signing of the contract.

**negative) that reflect:**

- the suggested holding period for the investment;
- a least two opposing financial market scenarios (favorable, unfavorable) that can be substantiated through back testing against comparable past periods;
- an explicit and very visible statement that projected results should not be taken as an indicator of real future performance.

Already used by structured funds, this approach could be extended to the vast majority of funds that have fixed allocation objectives between asset classes (i.e., stocks, bonds, money market, real estate). This is true both for passive funds (index funds) and actively managed funds, given that performance for either type can be compared to the benchmark indexes.

This method cannot be used with fully discretionary funds (such as flexible asset allocation funds). In this case, the simplified prospectus should explicitly state that the given fund's management style prevents back testing anticipated future performance against market experience.

Regarding **life insurance**, a possible solution would be to model projected returns for each fund choice individually, including money market funds. The aggregate results for invested capital over an eight-year period could then be shown in a summary table.

### ***2.1.3. Better defining the target investor profile***

Producers must strive to **identify the savings needs** that their products are designed to satisfy by determining the target investor profile:

- refinement of the standard classification of needs (interest on cash balances prior to reinvestment, income payments with or without capital drawdown, capital growth to finance a home or other medium-term project, retirement or estate planning),
- product suitability relative to investor risk appetite/aversion.

This effort is necessary both to guide investor investment choices and to steer product distribution towards the right customer targets. The profiling should permit a **clear statement designating that the product is intended for the mass market or qualified investors**.

#### **The regulator should monitor the suitability of this profiling.**

As with hedge funds, the regulator should restrict marketing to qualified investors if a product is judged overly complex or has an excessive risk of misselling. This does not mean that all investment products require similar limitations.

Concerning UCITS, article 44 of the previously cited directive allows the French regulator to set rules for marketing. It is therefore possible for the Host State regulator, pursuant to Court of Justice of the European Communities (CJEC)<sup>12</sup> case law,

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<sup>12</sup> The CJEC considers, with the exception of areas harmonized at Community level, that Member States set conditions for commerce within their territories. The Member States can only use this freedom to restrict services or trade in certain products if their national laws are proven:

- non-discriminatory;
- motivated by the public interest;

to **limit marketing of coordinated UCITS to qualified investors when these funds are viewed as risky or especially complex**, and even when they have been authorized in another Member State. This arrangement is obviously justified by the public interest need to protect consumers who are ill informed and/or lack the financial resources to support possible losses. It is proportionate to the directive objective and in no way constitutes a de facto interdiction to provide services in the Host State since qualified investors in the Community sense of the term (institutions and well-informed individuals with substantial portfolios) represent, in France, and probably even more so in other Member States, a predominant share of the total market for financial instruments.<sup>13</sup>

**The same recourse should be admitted for other products** (closed-end funds, structured instruments<sup>14</sup>) **that have completed a public offering in France**. Products listed in a Member State that enter the French market after home country authorization but without a public offering should not be allowed by the European Union. These are listings of convenience that do not create a true market for the product and whose sole goal is to bypass the rules of the other Member States. It would thus seem advisable, for the vertical integration of the European market, that the **possibility of restricting marketing of particularly risky and/or complex financial products be opened to all Member States within a harmonized framework**.

More specifically, regarding the distribution of these products via a UCITS, **a common position at Community level aimed at including them within the 10% limit for UCITS investment in “other assets”** is suggested.

Furthermore, a number of modifications regarding these products should be considered for the French market in the near term:

1) When **sold through unit-linked life insurance contracts**, the products should have a term at least equal to the minimum suggested investment period for life insurance, namely eight years. It is additionally proposed, subject to regulatory standards to be defined,<sup>15</sup> that unit-linked investment in these products be

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- designed to achieve the desired objective;
  - proportionate;
  - there is no equivalent legislation in the service provider's Home State;
  - there is no preliminary harmonization.

The CJEC judgment of March 18, 1980 (Debauve), states: “In the absence of any harmonization of the relevant national laws, a prohibition of this type falls within the residual power of each member state to regulate, restrict or even totally prohibit television advertising in its territory on grounds of general interest. The position is not altered by the fact that such restrictions or prohibitions extend to television advertising originating in other member states insofar as they are actually applied on the same terms to national television organizations.”

This ruling allows the French regulator to restrict UCITS marketing in view of both Article 44 of the UCITS directive, which specifies that the directive does not cover all aspects of marketing, and because a restriction to qualified investors remains proportionate.

<sup>13</sup> On this point, an order now being drafted should reproduce items in the Prospectus Directive that extend the idea of qualified investor to individuals if they satisfy at least two out of three criteria:

“a) the investor has completed an average of at least ten significant securities transactions per quarter during the previous four quarters; b) the investor's security portfolio value exceeds €500,000; c) the investor works or has worked in the financial sector for at least one year, in a professional capacity requiring an understanding of security investment.”

<sup>14</sup> Notably structured bonds and certificates.

<sup>15</sup> The definition of products subject to this restriction could encompass various factors such as:

- the combination of at least two financial instruments, where the risk exceeds that of each component

restricted to the **10% limit for “other assets.”** This could be enforced by French regulatory authorities since, unlike with the UCITS example above, there would be no conflict with existing directives

However, in order to avoid unfair competition, the **AMF could adopt the same standards** that would adopted for life insurance, **limiting UCITS marketing to qualified investors** for funds with more than 10% of assets invested in these products.

2) **Direct sales of these products** could be addressed through a series of measures:

- The regulator might require **advertising materials to include additional information** that stresses complexity or risk (see 2.1.4.). The AMF could enforce this by mandating specific wording that must be included in these documents.
- The regulator could issue **advisory notices** in response to particularly risky or complex products brought to its attention for which marketing limitations are presently precluded by Community regulations. **These notices emphasizing product features could be made public on the AMF website or via the press;**
- Distributors must adopt **equal standards**. They should not target consumers with products comprising the same risk profile and complexity as funds that have been or could be restricted to qualified investors at the time of authorization. When in doubt, they should consult with the regulator. More generally, the AMF could monitor adherence with these guidelines by checking marketing documents provided by issuers.

These measures cannot be as effective as a clarification of the Community’s legal framework. Nevertheless, they would help respond to competitive anomalies existing between UCITS and other financial products that now undermine effective regulatory supervision of product marketing.

#### ***2.1.4. Monitoring product advertising***

Financial product advertising remains a too frequent substitute today for pre-contractual documents that are still overly complex. Numerous investors make decisions based strictly on this advertising material, now subject to limited oversight.

In accordance with the AMF’s General Regulations, advertising must adhere to three guidelines:

1) **Correct, clear, not misleading**<sup>16</sup>: The UCITS simplified prospectus, structured and written so as to be easily understood by the investor, must provide

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taken separately (which corresponds to MiFID’s definition for complex products) . This particularly applies to an embedded derivative that substantially modifies the risk-return profile of the host product;

- use of leverage;
- presence of significant non-market risks (especially risks linked to legal complexity);
- lack of transparency (specifically regarding investment strategy).

<sup>16</sup> This principle has been adopted in MiFID Article 19 Paragraph 2 for all financial products covered by the directive.

transparent, clear and complete information.<sup>17</sup> This also applies to other financial instruments whose marketing communications “must not include false or misleading information.”<sup>18</sup>

This requirement is similar to that applicable to all products under France’s consumer protection laws (*Code de la Consommation*). Practical examples include explicitly indicating the limited duration for the exceptionally high interest proffered by certain savings products to lure customers, or advising that PEA investment account gains are not “tax free” after five years, but are rather still subject to a levy of 11%.

2) **Balanced:** The least favorable features and inherent risks should be shown, as needed, to counterbalance the stated advantages for each product option.<sup>19</sup>

3) **Consistent with the proposed investment:** i.e., no conflict with a product’s pre-contractual or contractual information.<sup>20</sup>

In this respect, it is proposed that product **advertising clearly point out the six key features discussed above.**

The AMF now has the authority to enforce these guidelines, including with “passport” products,<sup>21</sup> given that Home Member State competence does not supersede that of the Host State with regards to financial product advertising (Prospectus Directive Article 15).

In order to ensure concrete implementation, the three guidelines should be included in **conduct of business standards applicable to each category of distributor** (banks, insurers, brokers, etc.), under conditions that will be developed in Section III of this report.

The three guidelines should additionally be applied to real estate investment fund advertising (SCPI and the future OPCI), which currently is not the case. Most importantly, these criteria should be **added to the Insurance Code** so as to be applicable to life insurance contracts overseen by CCAMIP, France’s insurance watchdog.

Three types of action are proposed to control financial product advertising (press, TV/radio, point-of-sale):

First, network banking **standards and practices** (see 3.3.) and insurance company **internal compliance** should assume responsibility for **monitoring advertising and its adherence with relevant conduct of business rules.**

Second, **regulators** should strengthen **pre-publication supervision**<sup>22</sup>

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<sup>17</sup> RGAMF Article 411-45.

<sup>18</sup> RGAMF Article 212-28.

<sup>19</sup> RGAMF Article 411-50 for UCITS and article 212-28 for other financial instruments.

<sup>20</sup> This principle is affirmed by RGAMF Article 411-50 for UCITS, and RGAMF Articles 212-28 and 212-29 for other financial instruments (“any information related to a public offering, whether oral or written, must adhere with the information contained in the prospectus”).

<sup>21</sup> These products may complete a public offering if subject to the Prospectus Directive, or be sold without a public offering if subject to the UCITS Directive.

<sup>22</sup> Pre-publication supervision is only allowed for the AMF, both with UCITS and complex products such as closed-end funds or structured products (RGAMF article 212-28).

**of advertising materials, whenever feasible, but in any event they must exert greater post-publication control on a timely basis.** This could be accomplished by assigning a few employees to monitor advertising in order to spot and limit infractions sufficiently early. Furthermore, promotional documents and advertising materials used in marketing campaigns could be verified during joint controls that may be organized by regulators with banking institutions and insurance companies, according to methodology that will be outlined in Section III of this report.

Lastly, **regulators should use the full range of powers at their disposal** to correct or sanction errors or omissions, which depending on seriousness might include:

- forced rectification or recall of advertising documents or messages;
- disciplinary sanctions;
- publicized notices of orders and sanctions on regulator Internet sites and in the press.

#### ***2.1.5. Strengthening information requirements for financial products purchased with loans***

The use of loans to purchase financial products can prove extremely risky and thus merits specific information.

This type of financing not only undeniably boosts the fees borne by the investor (load fees or expenses plus loan interest), the return profile is also very uncertain. Substantial losses can result, which could exceed the initial investment in the event of a market downturn.

Although these packages cannot be actively promoted and demand institutional vigilance regarding credit risk, providers should likewise be required **to indicate the minimum return needed from this type of investment to cover the fees and resulting interest charges.**

Moreover, it would be prudent to **prohibit the use of leveraged products such as OPCI or highly-leveraged UCITS as investment loan collateral.**

## **2.2 Better retail network target marketing of savings products**

The major banks and insurers must improve savings product marketing in order to prevent misselling and to foster sales that meet the diverse savings needs of their network customers. This can be achieved by routinely applying and perfecting three best practices that emerged during the interviews conducted by this Review:

- customer segmentation;
- differentiated product range;
- sales force organization by expertise.

These could be explicitly incorporated into **professional conduct of business rules** (for the banking and insurance networks) and overseen by **internal compliance** and external regulators.

### **2.2.1. Refining customer segmentation**

This segmentation is practiced today to varying degrees, mostly based on **customer asset levels** held in a given institution. Depending on the bank, **two to four customer segments** are generally distinguished:

- at minimum, retail banking customers and private banking clients;
- in the best cases, three levels of retail banking customers are identified - mass market, intermediate, and high income - plus high net worth individuals benefiting from asset management and customized advisory services.

This best practice should be adopted by all institutions and then tailored to fit their specific approaches. It could be enhanced in line with improving knowledge of the customer, through attention to all of a given customer's assets, including those held or managed by other institutions.

Most importantly, this segmentation should be rounded out, as is already the case at certain institutions, by **consideration of other factors**, notably **age, marital situation and socio-professional status**, which would enable target marketing to integrate the varying needs linked to different life-cycle stages.

### **2.2.2. Greater differentiation of product range**

Alongside the product profiling requested from producers (see 2.1.), **product range differentiation** by customer segment seems increasingly warranted.

A certain number of institutions interviewed by this Review have already or are now organizing simplified product ranges with a more limited number of options geared to the mass market or intermediate customer segments. This trend should be encouraged. The accumulation of increasingly complex products, although probably appreciated by higher net worth customers or their advisors, can nevertheless be a source of confusion for lower income investors or the average investor. In the same way that too much information results in information overload, **too many choices can compromise the right choices**.

More generally, and in line with the differentiated approach required for enhanced segmentation of the customer base, two categories of products should be better distinguished:

1) **Standard products** capable of being integrated within simplified ranges that meet the primary needs of most investors. Examples in the current market context might include:

- a savings deposit account paying minimal interest on cash balances (probably a better solution than a money-market mutual fund given the very low interest rates);
- PEL accounts to finance the acquisition of a home;
- a traditional life insurance policy (or its underlying fund) used to build financial assets (indirectly but primarily invested in bonds) while also providing death protection;
- a stock fund, indexed or guaranteed depending on the degree of risk



aversion (possibly as part of a unit-linked life insurance contract), to benefit from long-term investment returns;

- a retirement product as needed.

Mutual fund types such as “conservative,” “balanced” and “dynamic” naturally have their place in a standard or intermediate product range, on the condition that these labels designate comparable asset allocation strategies at all institutions, which is not the case today. The investment community should strive to harmonize the use of these terms, even if this leads certain institutions to add even more “protected” or “aggressive” funds to their line-ups.

2) **Diversified products** that round-out the standard range for customers that require more elaborate savings solutions.

The two categories could be used to direct the target marketing of the product range, thereby guiding customer selection among available options and facilitating the advisory services provided by the salesforce.

Furthermore, independent of producer marketing strategies and possible regulator restrictions concerning the riskiest and most complex products (see 2.1), **distributors could, in practice, reserve these types of products to customer groups best able to measure the impact and support the risks.** This would be accomplished by developing a suitably organized frontline salesforce and advisory team.

### *2.2.3. Hierarchy of sales advisor responsibilities and expertise*

It is important to guarantee that the network salesforce has the necessary competence to sell the products they are authorized to offer customers in an appropriate fashion.

#### *2.2.3.1. Tiered salesforce organization*

The solution adopted by a majority of institutions interviewed consists in creating salesforce hierarchies, even within retail banking. These institutions have defined at least three and sometimes four tiers of sales advisors with varying responsibilities divided between branches, groups of branches or regional divisions and bank headquarters.

The first level is dedicated to mass market customers, with authorization usually limited to the sale of banking products (savings accounts, PEL, PEP, CODEVI, etc.) or, in certain cases, traditional life insurance. A second tier, dedicated to intermediate customers, is authorized to sell a small range of investment funds (managed profile, other), unit-linked life insurance with limited investment options, and capital-protected structured products. Lastly, a third advisor group is often assigned to higher net worth individuals or estates not eligible for private banking. These advisors are authorized to offer a larger selection of investment funds, unit-linked life insurance options and other diversified products.<sup>23</sup>

**This approach to salesforce tiering should be encouraged, including within insurance agency networks.** Although a two-pronged insurance

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<sup>23</sup> In addition to managing their own customer portfolios, these sales advisors are sometimes used as backup for the mid-level sales team (i.e., for the sale of SCPI or other tax-related products).

salesforce structure is probably sufficient given the lesser differentiation between insurance products, the sale of unit-linked contracts with numerous investment options does require a different degree of financial expertise compared to traditional life insurance.

#### *2.2.3.2. Adapting sales advisor expertise*

The underlying utility of this tiered structure is to help tailor, particularly through training, sales advisor expertise to the products they are authorized to sell.

This fit can be achieved by withholding sales authorization for certain products until professional certification has been attained through appropriate training. The insurance industry uses this method, with insurers or other intermediaries certifying sales advisor completion of a training cycle. Although some suggest extending this to other financial products, the system's drawbacks include a degree of rigidity and problems with ongoing monitoring.

Another solution, more flexible but perhaps more effective, would be to **provide retail banking sales advisors** (starting with those authorized to sell financial products) **with a training "record book."** This would be used by training organizations to record coursework completed by the employee, including both initial and continuing education on general and more specialized financial topics. The record book could also list the employee's direct practical experience in the sale of financial products.

This ongoing monitoring and customized training must be viewed as a fundamental obligation for proper marketing. From this standpoint, banks should take advantage of the pending renewal of their employee base linked to massive staff retirement in the next few years to **develop specific training programs** for new and future sales advisors **that cover financial products and their marketing.**

Independent of measures that may be implemented by individual institutions in this area, the banking profession, through joint FBF and AFG action, could take the lead by creating officially approved training programs.

### **2.3. Provision of suitable advice**

An improvement in the marketing of financial products implies the guaranteed provision of suitable advice to investors, whether they are solicited by a distributor or seek advised selling. To ensure the provision of such advice, it is necessary to:

- define the scope and breadth of the minimum advice required to promote financial products in the context of advised sales;
- implement advisory support resources with a view to facilitating and enhancing the security of sales advisory work in retail banks and insurance companies, with such support tools also used to record any advice issued.

### **2.3.1. Definition of the scope and breadth of the duty to provide advice**

When the retailing of financial products takes place in the context of advised sales, distributors must supply a minimum amount of advice. To enable this, the scope and breadth of advice must be specified and should be explicitly mentioned in conduct of business rules.

#### **2.3.1.1. Definition of the scope of the obligation to provide advice**

The obligation to provide advice concerns sales which might be concluded as a result of the following:

- **targeted solicitation of the customer by a salesperson**, which would generally focus on one or several specific products, either through prospecting, direct mail or on-site offers.
- **a request for advice by the customer, either in his bank branch or with an FIA or insurance intermediary**, where such a request may focus on one or several specific products, or on the investment of a relatively important sum without indicating any preference for a given product.

Consequently, with the exception of insurance products, the obligation to provide advice is **not applicable within the context of the execution of a specific buy order** made by the customer on his own initiative and without any request for advice on his part. This is the situation, exclusive of that involving advised selling, covered by MiFID Article 19, paragraphs 5 and 6.<sup>24</sup>

In this respect, it is important that the investor should be able to identify clearly the dividing line between the execution of an order and advised sales. In particular, when Internet platforms are not limited to simply offering information relating to products and the reception/transmission of orders but also provide asset allocation models geared to the potential investor's risk appetite/aversion, resulting in the recommendation of one or several products, the situation is no longer that of order execution and the obligation to provide advice is fully applicable.

Likewise, when **a customer visits a branch to meet with a sales advisor, any resulting purchase of financial products must be assumed to have taken place in the framework of an advised sales process.**<sup>25</sup>

In the case of straightforward execution orders, which are generally not made in person, it is the responsibility of the service provider to **prove that "execution-only" terms have been met**, by producing written confirmation (mail or fax) of the order.

**Thus defined, the obligation to provide advice should apply to all distributors and for all savings products** (banking products, life insurance,

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<sup>24</sup> Article 19.6 concerns only investment firms providing investment services "that only consist of execution and/or the reception and transmission of client orders." Moreover, it allows them to provide these investment services "without the need to obtain the information or make the determination provided for in paragraph 5," which relates only to the provision of investment services other than investment advice and portfolio management.

<sup>25</sup> This is the definition of advised sales which is likely to be proposed by France in the framework of level 2 discussions for MiFID.

UCITS, shares placed directly as part of new stock market listings or privatizations, structured products involving active marketing, etc.), as well as for all distribution channels (whether face-to-face or remote marketing).

To ensure the harmonious application to all distributors of the obligation to provide advice, it is proposed to:

- **extend the measures in the insurance mediation directive to employees of insurance companies**, with a view to preventing unequal treatment of investors, depending on whether companies sell directly through their employee networks or use intermediaries;
- **extend the FIA rules regarding obligatory advice to regulated professions** (e.g. real estate agents, notaries, lawyers, accountants) whose ancillary business is financial advice and the sale of financial products. To do so, these rules might be included in the conduct of business standards for these professions or made directly applicable to these professions under supervision of the financial regulator.<sup>26</sup>

#### *2.3.1.2. Determining the scope of minimum diligence required in advice provision*

Both the insurance mediation directive and MiFID suggest that there are two aspects to advice provision for investors:

- the obligation to **“know your customer,”** implying an examination of their financial situation, investment targets, investment timescale and appetite for risk.
- **identifying one or several suitable products** to meet their needs.

For both aspects, regulation can only impose minimum standards aimed at guaranteeing consumer protection, leaving it up to the competitive marketplace to ensure the best possible quality of advice.

Defining the scope of these minimum requirements involves determining the **minimum content and best possible combination of the two aspects** of the duty to provide advice. The main difficulty is to determine the correct timing between questioning the customer and finding the most suitable product(s), while bearing in mind the need for consistent customer segmentation recommended in this Review (and already implemented by several financial institutions).

The salesperson must first ascertain the **sum to be invested**. If it involves an initial investment by the customer or potential customer with that financial institution, the salesperson should ask questions in order to establish a minimum amount of information concerning the customer. This assessment process could take place according to the following order:

1) The salesperson should first assess the **customer’s financial position**, weighing factors such as income and gross financial assets held, including, when applicable, in other institutions. The customer or potential customer should be

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<sup>26</sup> This obligation to provide advice could also be applied to trustee managers, for whom a minimum standard of financial competence should be established.

questioned on this last point,<sup>27</sup> and **age** and **marital status** should also be considered (see 2.2).

The customer's answers to the above questions should enable the salesperson to **determine the applicable customer segment** defined by the financial institution and hence offer the product range options available to that segment.

2) The salesperson should then inquire about the customer's **investment objectives**: interest on cash savings (held as a precaution or in anticipation of long-term investment), home financing, longer-term savings to generate additional income or capital appreciation and/or death protection, retirement planning, etc.

Depending on the answers to these questions, the salesperson should be able to **identify the product(s) in the applicable product range best suited to meet these investment objectives**.

3) Subsequent questioning of the customer would then **depend on the nature of these products and may vary based on their level of liquidity, risk and complexity**.

If the **product** that suits the customer's objectives is both **liquid and fully capital protected**, such as a standard savings account or tax-advantaged savings account linked to acquisition of a home, the obligation to provide additional advice to the customer is limited. The availability of the sum to be invested must be verified, and if the customer is carrying costly debt elsewhere, he should probably be advised to start by paying off the debts.

If the **product(s)** suited to the customer's objectives is **fully capital protected but entails a relatively long holding period** to reap the full benefits (i.e., PEL home savings plans, traditional life insurance policies, fully-guaranteed structured funds), additional information is required concerning the customer's investment timescale and ability to set aside the given sum for the required duration in the light of income, spending requirements and other liquid assets.

If the **product(s)** suited to the customer's objectives is comparatively basic but is **not capital protected and consequently implies a relatively long holding period** (e.g. equity, bond or profile funds, unit-linked life insurance contracts, SCPI property funds), the information gathered from the customer should cover risk appetite/aversion and the structure of other assets, which might also involve a greater or lesser degree of risk and/or be tied up. Advice provided should include at least some attention to asset allocation tailored to the customer's profile (as determined by the mass of information collected).

Finally, if the **product(s)** suited to the customer's objectives is **high-risk and/or complex** (e.g. leveraged funds such as FCPR, FCPI, FCIMT, OPCI, specialized funds, non-guaranteed structured funds and other structured products), it will be necessary to ascertain the customer's experience with these products and his net assets, particularly liquid assets.

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<sup>27</sup> Should the client refuse to answer this question, the financial institution cannot vouch for the quality of the advice it is able to provide.

In addition, advice must be guided by the general principle of **diversification**, which means that the customer's investment portfolio should not be too heavily weighted in favor of a single product.

It is important to bear in mind here that product selection should also account for **taxation**. However, tax issues should not be the sole driver for advice and advisors should take care to assess both the advantages and constraints involved. Although tax incentives exist to encourage certain types of investment, **the authorities should examine how incentives can lead to sub-optimal asset allocation relative to investors' needs and objectives.**

This more-or-less complete assessment of the customer's profile renders possible more rapid selection of suitable products for subsequent investments. However, the customer's profile should be **updated with each new "non-recurrent"**<sup>28</sup> **and significant investment.**

In any event, the financial institution's commercial interests are likely to motivate customer assessment updates whenever the customer's cash balance suggests that new investments should be proposed. A best practice clause could also be added to conduct of business rules stipulating periodic advisory meetings depending on the size of the customer's asset portfolio with the institution or in the event of a significant change in market environment that could adversely impact the portfolio.

### ***2.3.2. Developing advisory support resources***

Advisory support resources should be made available to sales advisors to facilitate customer profile assessment and identify suitable products. Two background factors explain why such tools are necessary.

First, sales advisors need help to **overcome their reticence about offering capital risk products to customers**, particularly equity-based UCITS. This reticence concerned most retail institutions interviewed by this Review, and the support materials would provide sales staff with a degree of cover for their recommendations.

Second, and just as important, is that **advisory activities must be organized on an "industrial" scale** so that the cost of extending such services to wider categories of customers is not prohibitive.

Consequently, this Review proposes that **standard questionnaires, possibly including suggested recommendations linked to customer responses**, should be drawn up by financial institutions<sup>29</sup> to assist advisory sales staff. Certain interviewed financial institutions, networks and platforms have already implemented or undertaken such measures.

Although such tools can neither substitute for training (see 2.2.3) nor replace the individualized approach required from advisors, they should assist the salesforce in carrying out the minimum level of "due diligence" necessary to assess

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<sup>28</sup> This obviously excludes regular payments as part of a fixed premium life insurance policy or a timetabled savings plan.

<sup>29</sup> Or by the industry as a whole, should it prefer to do so.

the customer's financial situation, investment objectives/timescale, and risk profile, thereby enabling the recommendation of suitable products to meet these needs.

Further out, normal competitive market forces should encourage financial institutions to develop (or buy) advisory staff support resources of a more sophisticated nature that can be used to assess private wealth profiles and optimize asset allocation. Some retail networks are already adopting such tools, with a view to differentiating themselves on the basis of advice quality.

### ***2.3.3. Maintaining records of the advisory process***

Advisory support services should be closely tracked and recorded by insurance companies and intermediaries as well as by retail banking networks and FIAs.

The insurance mediation directive, which is being transposed, will oblige insurance intermediaries to keep a record in a **durable medium** of advice services. Likewise, MiFID article 13.6 obliges investment firms to **maintain a record** of all services and transactions undertaken, thereby enabling the regulator to control whether the investment firm has complied with all obligations with respect to customers or potential customers.

Only accurate records of personal recommendations can provide distributors with **essential proof in the event of dispute**, thus offering protection to both the sales advisor and the retail network. France's Court of Cassation, in its judgment of January 7, 2004, decided that the professional rather than the customer has the burden of proving that advice has been correctly provided. Consequently, this implies that a material record of the advice must be retained.

In addition, recordkeeping (paper or electronic) for all information obtained and advice proffered is **indispensable to evidence compliance or for internal controls**, whose purpose is to enforce the rules of conduct applicable in this area.

As a minimum requirement, therefore, a sales advisor, whether an employee, FIA or insurance intermediary, must **record customer answers in their standard questionnaires, along with the ensuing recommendations**. This information should be kept in the customer's electronic file for the duration that a product(s) is owned, or at least for the suggested holding period for the investment.

Furthermore, **a copy** of the questionnaire and the advice given should be **offered to the customer**. Assuming this is done with customer appraisal software, such copies would entail little cost. However, it is not recommended to require that customers sign the copy, since experience demonstrates that this provides no real guarantee for the customer and would excessively formalize the customer-sales advisor relationship.

This **record-keeping obligation should also apply to advised sales of a remote nature**, by retaining electronic correspondence, recording telephone conversations or keeping the written confirmations that are often required.

## **2.4. Safeguarding the objectivity and impartiality of advice**

To ensure that advice culminates in the best product choice corresponding to the investor's interests, it must not be skewed by unwarranted inducements to sell one product rather than another. Such a bias can be introduced by **sales advisor commissions**.

This problem does not arise in the same way with integrated retail networks (where distributors and producers are linked) as with independent distributors.

### ***2.4.1. Integrated networks***

In integrated networks, the problem is not the compensation of the distribution entity (determined based on varying methods depending on the group) since this does not directly profit sales staff.

However, sales advisors can be induced to favor the sale of particular products:

- either temporarily, during marketing campaigns at the time of product launches;
- or permanently, depending on how the sales volume for a particular product is weighted in terms of the overall calculation of their variable compensation or as part of their in-house appraisal by superiors.

The intention here is obviously not to question the viability of marketing campaigns, variable pay for sales staff or assessing sales results as part of the appraisal process. However, the following recommendations are made to avoid skewed advice and the ensuing risk of misselling.

- **Variable compensation plans**, where they exist, **should be limited to a reasonable percentage of the employee's income and draw on the greatest possible number of products**. A given product's weighting in the total calculation should correspond solely to the degree of difficulty associated with its sale.
- Variable pay should be based not only on sales volume but also on **more qualitative factors**, such as customer portfolio trends or the monitoring work involved.
- The appraisal process for sales advisors should be based on the same principles.
- Sales staff should not be subject to excessive pressure during marketing campaigns focused on any single product.

Note that once integrated distributors have implemented advisory support tools, geared to choosing the most suitable product(s) for an investor's needs, the nature of marketing campaigns will change. Rather than one-off campaigns to promote a single product, they will increasingly be theme-based and take the form of an ongoing assessment of customers with a view to rounding out their investments.

The above points should warrant **special vigilance from internal compliance or control**. To enable this, it is proposed that retail banking compliance



officers or insurance company controllers participate in designing sales advisor variable compensation plans and appraisal review procedures, as well as in the preparation of marketing campaigns.

Apart from such internal controls, there will also be external monitoring by the regulatory authorities in this area (see 3.4).

#### **2.4.2. Independent distributors**

With **independent distributors**, there is a greater likelihood of advice being skewed by pay methods, since these intermediaries receive **almost all their compensation from producers** in the form of commissions sharing derived from the customer fees paid directly to the producer (such as load fees that virtually all go to the distributors) or as a percentage of the investment (thus weighing on fund or contract performance).

Concern has been expressed that this system of compensation could lead to the kind of abuse seen in the USA, where producers can pay excessive direct or indirect commissions to distributors as an incentive to favor their products over those of competitors (see 1.3.2.).

Avoidance of these improper commission practices cannot be fully achieved by obliging FIAs and insurance intermediaries to indicate whether they are working exclusively with a single or limited number of producers whose identity may be made known to the customer. Nor would they be systematically avoided by distributors using platforms that can act as a buffer from producers, since such platforms may themselves be giving preference to certain products.

Two theoretical solutions can be advanced, drawing on examples from abroad:

1) The **United Kingdom** requires that the distributor display the share of commission he receives from each producer and for each of the products he distributes.

Known as a “menu document,” this system is very complicated to implement and would be a handicap for a profession whose development should be encouraged. Furthermore, this Review is not convinced of this system’s effectiveness:

- The consumer is not really qualified to judge whether the commission rate is normal. This is true despite the UK regulator’s plans to publicize the average market rates.
- Other less obvious distributor compensation methods exist. These “soft commissions” can take the form of conferences, training courses, trips or “gifts” linked to the number of products sold. These are not covered by the obligation for transparency.
- This type of solution would be biased in France, since it would be inapplicable to integrated networks and would thereby penalize the independent distributors.

2) The **United States** requires that producers disclose distributor commissions as part of the prospectus information on product fees.

This solution is also of doubtful effectiveness for the consumer and would have the same distorted result as the UK solution for independent distributors. Fundamentally, what is important for the consumer is not a breakdown of fees between distributors and producers but **the overall cost of the product and the impact of total fees on performance**. This Review has made recommendations

on this issue with a view to improving transparency (see 2.1.1.2).

Given the above, the Review endorses a third solution, based on **stricter regulatory supervision in this area**. It is proposed that **producers disclose on an annual basis the commission rate paid out in the previous year for each product and each distributor**. This data could be used to determine market averages by product type and to identify apparent discrepancies.

Foreign issuers of financial products should also be required to make the same disclosure on the same terms regarding their French distributors. This would provide the regulator with full information and ensure a level playing field between French and foreign products.

Analysis of the data would initially enable the regulator to demand an explanation of discrepancies from producers and distributors. This could lead to **on-site producer and distributor audits** aimed at establishing whether not fully explainable gaps correspond to unreasonable distributor incentives to steer sales to the highest commission products. At the same time, the regulators could also investigate soft commissions.

When such practices are discovered, the regulator should use its power to issue cease and desist **orders** and/or **penalties**, both of which could be made public.<sup>30</sup>

Fund management compliance officers could also be usefully involved in monitoring compensation by **controlling non-cash producer contributions to distributors** and by ensuring that such contributions genuinely correspond to improved training or investor services.<sup>31</sup>

In addition to this suggestion, this Review has examined ways to encourage creation or development of **advisory service compensation through fees paid directly to advisors**. Such practices are not common today even with regard to IFAs, but would have the advantage of strengthening distributor independence from producers and guaranteeing payment for distributor advice, even where such advice has not resulted in a sale. After all, good advice can sometimes lead to portfolio streamlining, reallocation, or debt reduction, rather than the purchase of new products.

Consumer resistance to paying for advice is currently the main obstacle to fee-based compensation, although an additional problem is that consumer fees for financial products are subject to VAT, unlike with commission sharing.

This tax handicap could be partly offset by **allowing advisory fees to be deducted from investment income**, as is already the case for custodian fees.

The consumer reluctance to pay for advisory services might be somewhat mitigated if it was understood that **these costs would be deducted from load fees or**

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<sup>30</sup> With specific reference to managed trustee accounts, pending reform legislation in this area is likely to prohibit trustees from receiving commissions, except with the explicit agreement of a judge. Legislation is also expected to introduce stricter suitability requirements for trustees who engage in auxiliary activities that may impair their management objectivity (e.g., distribution of financial products).

<sup>31</sup> Although the organization of conferences or training courses by producers may seem legitimate, the same does not hold for gifts or personal benefits which have no connection whatsoever with product marketing or the financial advisory professions.

**other initial costs** if the advice resulted in a product sale. This could possibly lead to the establishment of modest charges to compensate the time devoted to advisory services, even within retail banking networks.

### ***2.4.3. Product selection***

Minimum standards of diligence applied to advice will guarantee that investors receive proper asset allocation and the right product fit for their needs. However, the choice of a specific product, albeit less of a determining factor for investors, can be **skewed by the distributor's product selection**. Retail banking networks principally, if not exclusively, offer their customers proprietary products, IFAs can only propose products for which they have received producer authorization, and platforms generally present a select number of products. Consequently, the composition of distributor product ranges, within which a choice may be made, can be biased (see 1.2).

For this reason, it is recommended that the integrated banking networks and insurers (including their general agents) require distributors to tell customers **whether offered products are exclusively proprietary or originate from other producers**.

At the same time, the IFAs, platforms and brokers should indicate, when appropriate, **their preferred producers** among the full range they claim to represent.

## **2.5. Promoting greater responsibility**

The satisfactory marketing of financial products implies a greater sense of responsibility and the fulfillment of obligations on the part of all concerned. In this respect, three adjustments are required:

- clarification of the respective duties of producers and distributors;
- launch of financial product broker legal status, providing distributors with greater independence from producers and enabling them to shoulder full responsibility for sales;
- measures to assist the consumer in assuming responsibility.

### ***2.5.1. Clarifying producer and distributor obligations***

General rules should be drafted to clarify the key responsibilities of producers and distributors.

Although the **producer** is obviously solely accountable for **product conception**, his responsibility also extends to three other areas:

- origination of **contractual documents** and **product information**, and especially product **profiling**, i.e., the definition of the target investor profile<sup>32</sup> (see 2.1.3.);
- supervision of distributor **marketing and advertising material**

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<sup>32</sup> When the product is ordered by the distributor, the producer's responsibility is limited to the correct interpretation of the investor profile target specified by the distributor.

**conformity with contractual documents.** This requires distributors to submit documents to producers in advance;

- **arrangement of all necessary training for distributors** to ensure correct marketing of new products.

The **distributor** is solely responsible for **transmitting information and providing advice to the customer** (see 2.3.1.).

In integrated networks, producers generally respond to needs as defined by the retail bank's specifications. This situation has no impact on the recommendations concerning responsibility, since the entity in question acts as both producer and distributor.

However, when an integrated network production subsidiary, or any other management company, responds to product requests from other distributors, **it is important - even if the product must comply with distributor imposed specifications - that the producer indicates the target investor profile** for which the product is intended.

Apart from these separate areas of responsibility, agreements between distributors and producers may stipulate shared areas of responsibility or adjust other respective obligations of a contractual nature. Consequently, it is recommended that the producer-distributor relationship should be systematically formalized through **written agreements**.

The professional bodies could usefully contribute by drafting standard agreements that would assist producers and distributors in this formalization process.

### ***2.5.2 Launch of financial product broker status***

FIA's must now be licensed by producers in order to market their products. Apart from the inconvenience, this limits the range of products offered and the independence of FIA's relative to the producers. Furthermore, this arrangement means that producers bear full responsibility in the event of conflict, given that the FIA's are licensed and are therefore viewed as producer agents.

Internet platforms provide only a partial solution. Acting as investment firms, these platforms can license FIA's and enable marketing of all products offered by the site. However, this still limits the number of products that can be marketed by FIA's, since the Internet platform will have made a preliminary selection among available products. Moreover, responsibility here still lies with the platform.

In order to strengthen FIA independence relative to producers, confer genuine responsibility on FIA's for their sales and advisory activity, and harmonize distribution methods for financial and insurance products, it is recommended that a **financial product broker status** be created, given that brokers are commonly understood to represent their customers and not the producers.

FIA's could then opt to act as either licensed agents or brokers, in the same way that insurance intermediaries can be general agents or brokers.

### **2.5.3. Helping guide consumer responsibilities**

Although a key recommendation of this Review concerns the provision of information to investors prior to the purchase of a financial product, this will only be beneficial if the potential buyer is capable of understanding the information. Likewise, while distributors are being asked to respect minimum standards in terms of advice, this cannot fully offset insufficient consumer knowledge of financial products.

It is therefore essential that **investors** should be provided with educational tools to assist them in understanding their obligations. Consumers **will always be ultimately responsible for their choice of investment**. Irrespective of the enhanced consumer protection measures implemented by the regulator and professionals, the final responsibility for consumer satisfaction falls largely on the consumer.

#### *2.5.3.1. Educating financial product consumers*

Consumers of financial products will be unable to assume their responsibility if they cannot understand key product-related information. It is with this in mind that an AMF working group has proposed the creation of an **educational organization for investors**, geared to improving consumer economic and financial awareness through the use of all possible training and information channels.

The priority here is to **teach consumers to ask the right questions** when considering a product purchase or meeting with a sales advisor. To achieve this, the investors' educational organization could work usefully with the consultative committee for the financial sector (CCSF) to examine and publicize the essential questions that should be asked. The six key product features (type, guarantee, minimum recommended holding period, risk/reward ratio, fees, target investor profile), presented in this Review (see 2.1), could be used as a basis for this work.

It is also necessary to relate a number of **fundamental ideas** to investors, especially concerning the close links between return, risk and investment duration. It must be clearly expressed that liquid, risk-free products cannot provide investors with high returns and that return is linked to risk-taking, but also that risk can be significantly reduced by lengthening the investment holding period (see 2.1 and appendix VI).

#### *2.5.3.2. Performance monitoring and reporting based on recommended holding period rather than annual results*

Financial product performance should be calculated in a way that reflects these key ideas and boosts investor awareness regarding the importance of the recommended investment holding period. For example, the publication year-after-year of annual fund performance, for which the recommended investment period is five or eight years, borders on dishonest product advertising.

Instead, it would be advisable to **report annualized performance data calculated using a moving average corresponding to the suggested investment holding period**.

This recommendation, more general than the AFG's (*Association Française de Gestion*) recent advisory to its members, should be included in professional conduct of business rules. It is also addressed to the economic and financial press, which plays an important educational role for consumers in this area.

*2.5.3.3. Improving consumer information and promoting independent review of financial products*

Besides the performance data, **investors should have access to simpler and more intelligible comparative financial product information than available today**. Products are now frequently reviewed, either by the financial media or the rating agencies. However, the methods applied often differ in approach, lack transparency and fail to allow for clear comparisons between products.

In order to facilitate such comparisons, it is recommended that the regulator form a **working group** whose mission will be to explain and harmonize performance tracking and forecasting methods (see 2.1).

This work could be formalized by the creation of an **Internet site that provides all comparative data to consumers**, either under the aegis of the regulator (comparable to the British regulator's release of comparative tables) or that of independent consumer associations.

## **2.6. Improving after-sales service**

Although financial product marketing is designed to lead to sales, the purchase of a product by an investor does not end the sales relationship. It is important that investors, for the entire product lifecycle, benefit from information and advice in the event of product changes, as well as the right to appropriate forms of redress in case of dispute.

### *2.6.1. Monitoring changes to contract or product terms*

Financial products once bought or sold can still be modified. As a **general rule, investors and policy holders must be informed of product changes** that may have an impact. More specifically, this principle implies that producers and distributors have certain minimum obligations.

First and foremost, producers must inform holders of shifts in fund management approach. For UCITS, **changes in management strategy**, if not explicit at time of purchase, should be **disclosed to investors** when these changes are likely to have a material impact. Furthermore, producers must ensure that these changes do not negatively affect holders, particularly in terms of taxation.

With respect to **“open contract” group life policies**, insurers must ensure that changes made to contract guarantees in agreement with the association master policyholder are done under the supervision of the association's governing bodies.<sup>33</sup>

Distributors also have a number of basic obligations to consumers during the life of the product. For banking products, it is their responsibility to

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<sup>33</sup> In this area, the French Senate's amendment to the law introducing several measures with respect to insurance will substantially improve oversight of association insurance programs.

notify investors of regulatory changes in interest rates, which might affect how the product fits with the needs of the investor. More generally, sales advisors or independent distributors must **reexamine the suitability of the initial investment in the event of a substantial change in revenue or tax treatment** relative to a given financial product.

Furthermore, when investors are presented with **changes affecting the product type or other fundamental features** (see 2.1), without any corresponding modification in the product's legal status, the distributor must provide **minimum diligence with respect to advice** (see 2.3). For example, when certain distributors offer to convert traditional life contracts into unit-linked policies, as will be possible from January 1, 2006, they must also undertake an additional review to ensure that the new investment still suits the needs and risk profiles of the investors concerned.

### ***2.6.2. Facilitating out-of-court settlements***

An investor might believe that necessary information or advice has not been provided and may seek changes or restitution for the purchase from the distributor, before resorting to litigation in the event of dispute. It is advisable to facilitate out-of-court solutions to resolve such disputes. This implies **proper handling by distributors of complaints and the possibility of mediation**. Such an approach helps to improve the sales process in two respects.

- Financial product consumers are able to assert their rights more rapidly and easily than through litigation.
- For the financial institution, it represents a valuable source of information about possible sales network irregularities and an incentive to find solutions, without the risk of damage to reputation from litigation.

All network banks and insurance companies would be well advised to set up a **centralized department to process complaints**, directly reportable to senior executives. This type of organization would guarantee the department's independence from the investment management units that initially marketed the product at the origin of the dispute. It would also ensure equitable treatment of complaints within a given network or company, irrespective of the customer's place of residence.

Information regarding complaints processing and full contact details for the department must be supplied to investors at the time of product purchase. Moreover, the launch of a complaints department and the disclosure to investors at time of purchase should be incorporated into distributor conduct of business rules.

If the complaint cannot be resolved through internal processing, alternative methods for dispute resolution, particularly **mediation**, should be preferred, as encouraged by European directives.<sup>34</sup>

Several mediation approaches now exist, with differences across sectors and even between companies. It was not within the scope of this Review to examine procedural rationalization for finance and banking mediation in France, despite the current lack of transparency in this area for the consumer.

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<sup>34</sup> Mediation's advantages include confidentiality, no cost and equal hearing of both parties.

However, a basic principle needs to be established and incorporated in conduct of business rules for all distributors: a **competent mediator is required for disputes involving savings products (financial or banking). Additionally, following internal rejection of a complaint, the investor should be informed that the mediator exists and be provided with full contact details.** This should also be included in distributor conduct of business standards.



### III.

#### IMPLEMENTATION

Most recommendations proposed in the second part of this report concern conduct of business rules that would have an even greater chance of being applied if supported by a collective commitment by the parties concerned. These rules must moreover be capable of being adapted with a great deal of flexibility to future changes in operating conditions and practices. For this reason it is proposed that they be incorporated into **conduct of business rules approved and recognized by public authorities**.

The application of these rules could in this way be ensured internally by “**compliance**” **procedures** implemented by the establishment themselves, supplemented by the **oversight of the regulators**, who after approving them would be able to sanction possible violations.

However, a limited number of recommendations concerning the obligations of professionals and the rights of third parties must be defined by legislative and regulatory provisions as outlined below.

#### **3.1. The introduction of a limited number of legislative and regulatory provisions**

##### *3.1.1. Legislative provisions*

These concern the implementation of recommendations relating to the scope of the obligation to advise consumers, tax provisions applicable to advisory fees and laws defining the responsibility and powers of regulators.<sup>35</sup>

For this reason, the law to be implemented for the transposition of the MiFID should include:

- on the one hand, **a definition of sales covered by an obligation to provide advice** in contrast to a buy order on an execution-only basis (recommendation 2.3.1.1.);
- on the other hand, the **definition of the respective responsibilities of the producer and the distributor** of savings products proposed in recommendation 2.4.1, as well as the creation of a status of **financial product broker for financial investment advisors** (recommendation 2.5.2).

This law could also **extend the obligation to provide advice** under this directive **to insurance companies distributing products through their networks of salaried employees** (recommendation 2.3.1.1.).

The law to be implemented for the transposition of the MiFID should also **extend to regulated professions** that furnish advice and sell financial products in a secondary capacity **the conduct of business rules imposed on financial investment advisors** on the basis of either of the proposals formulated in 2.3.1.1 of this report.

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<sup>35</sup> On this point, refer to 3.3.1. of this report.

Finally, a provision for deducting advisory fees from taxable investment income (recommendation 2.4.2.) should be introduced in a Finance Act.

### **3.1.2. Regulatory provisions**

Regulatory provisions<sup>36</sup> should define the obligations of producers and distributors in providing information, advertising and reporting to regulators. These include:

- 1) The obligation for the simplified UCITS prospectus and the prospectus of the life insurance policy to include information on the six key features identified in 2.1.1.2. of this report.
- 2) Extension to French SCPI and life insurance policies of rules on advertising applicable to UCITS (recommendation 2.1.4.).
- 3) The obligation of promoters of financial or life insurance products financed through loans to indicate in their marketing and contractual documents the **minimum return** of the product needed to cover the loan fees and interest expense (recommendation 2.1.5.).
- 4) The obligation of **producers to disclose on an annual basis the commission rate paid the previous year to** independent distributors and the obligation of distributors of imported financial products to disclose the rates they received (recommendation 2.3.5.).

### **3.2. Provisions to be included in conduct of business rules approved by regulators**

Most of the recommendations of this Review concern, as previously indicated, conduct of business rules for operating activities, generally based on the best practices identified in the course of the Review. It is proposed that these practices be incorporated into the conduct of business rules to be subsequently approved by public authorities rather than being implemented through laws and regulations, which are less easy to adapt to the evolving operating conditions of the activities.

#### **3.2.1. Conduct of business rules concerned**

Fifteen recommendations of the report listed below should be included in conduct of business rules.

##### *3.2.1.1. The pertinence of information provided on products*

- 1) The principle of **product profiling** by the producer, i.e., defining a target investor profile for the product by assessing the needs, investment horizon, risk profile and status of the investor as qualified or not (recommendation 2.1.3.).

##### *3.2.1.2. Retail network target marketing*

- 2) The principle of **customer segmentation** taking into account at the very least the financial assets, age and family situation of the customer (recommendation 2.2.1.)
- 3) The principle of profiling and **product range differentiation** by customer segment (recommendation 2.2.2.)
- 4) The principle of establishing a tiered salesforce organization (recommendation 2.2.3.1.)

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<sup>36</sup> Decrees, ministerial orders, the AMF General Regulation (RGAMF) or, where referred by the latter, instructions of the regulatory authority.

5) The principle of **adapting sales advisor expertise** to the products they are authorized to sell and follow-up of training (recommendation 2.2.3.2.)

*3.2.1.3. Provision of suitable and impartial advice*

6) **Minimum due diligence for providing advisory services** (recommendation 2.3.1.2.)

7) **Implementation of advisory support resources**, and notably standard questionnaires accompanied by recommendations concerning the nature of products to be proposed according to the customer's responses (recommendation 2.3.2.)

8) **Maintaining records** of the advisory process (recommendation 2.3.3.)

9) Assuring the principle of **neutrality in systems of variable compensation** and evaluating sales personnel on the nature of products proposed (2.4.1.)

10) Testing a system of **invoicing the investment advisory services** to be allocated, in the event of sale, to the fees for purchasing the product or contract (recommendation 2.4.2.)

11) The declaration of the distributor whether or not it proposes proprietary products on an exclusive basis, and when applicable, indicating the producers with which it works on a preferential basis (2.4.3.)

*3.2.1.4. Communications on the performance of the product or contract*

12) **Communications** on performances based on the **suggested minimum investment period** (recommendation 2.5.2.)

*3.2.1.5. After-sales service:*

13) Rules to be applied **if the product or contract is modified** (recommendation 2.6.1.)

14) Ensuring **fair treatment of claims** (recommendation 2.6.2.)

15) The **right of access to mediation** (recommendation 2.6.3.)

*3.2.2. The proposed procedure*

It is proposed that trade associations representing the sector concerned – the FBF (*Fédération Bancaire Française*) and the AFEI (*Association Française des Entreprises d'Investissement*) for credit institutions and investment companies, the FFSA (*Fédération Française des Sociétés d'Assurance*) and the GEMA (*Groupement des Entreprises Mutualistes d'Assurance*) for life insurance,<sup>37</sup> the AFG (*Association Française de Gestion*) for management companies and associations of insurance brokerage firms<sup>38</sup> – adopt these rules and principles through the application of conduct of business rules, as was done for financial investment advisors and some of the above already.

This would have the advantage of creating a comprehensive system of conduct of business rules:

- supported by a **collective commitment to compliance from all of these professions;**

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<sup>37</sup> For life insurance, other professional organizations are also concerned such as the FNMF, the CETIP and the FNIM.

<sup>38</sup> Today there exist two associations that are currently in the process of being merged.

- based on input more closely reflecting **actual market conditions and practices** and consequently easier to adapt to future changes than regulations drafted by public authorities.

For such rules thus incorporated in the conduct of business rules to be **binding on all establishments in the same sector where membership of a professional association is not mandatory** (insurance companies and brokers) and to **ensure that regulators have the authority to stop or sanction potential violations**, the conduct of business rules must be **approved by public authorities**. This may be done at the initiative of the professional associations themselves, by independent authorities responsible for oversight or by the French Ministry of the Economy and Finance after consulting with the competent authority, according to the sectors and the existence or not of delegations provided for by law.<sup>39</sup>

The professional associations should be given one year to draw up these rules. Of course, rules corresponding to the recommendations proposed in this report not implemented after this one-year period could be included in rules or instructions issued by regulators (the general regulation and instructions of the AMF, the regulatory section of the French insurance code, decrees or governmental orders following recommendations issued by the CCLRF – *Comité Consultatif de la Législation et de la Réglementation Financières*).

Finally, the approval of these conduct of business rules must define, based on proposals from the professions, a **timetable for implementation**, which naturally implies the application of deadlines.

### **3.3. Internal compliance monitoring**

Effective application of conduct of business rules for marketing savings products (whether originating from provisions of law, regulations or professional rules approved by regulators) must first be ensured by each establishment through internal compliance monitoring procedures.

The purpose of these internal controls, introduced in banking and financial regulation by the order of March 31, 2005 (taking effect on January 1, 2006), amending regulation 97-02 on internal controls of credit institutions and investment companies of the CRBF (*Comité de Réglementation Bancaire and Financière*), France's regulatory authority for banking and financial services, is to prevent "risks of legal, administrative, or disciplinary sanctions, material financial losses or damage to the company's reputation, resulting from non-compliance with specific provisions governing banking and financial activities whether resulting from laws or regulations, conduct of business rules and professional ethics, or instructions of the executive body issued notably in accordance with decisions adopted by the governing body."

**These procedures accordingly provide for ensuring compliance with professional standards** for which infringements may be subject to legal,<sup>40</sup> administrative or disciplinary sanctions through:

- professional rules approved by the AMF (articles L.621-15 II a of the *Code Monétaire et Financier* and L.621-17 concerning financial investment advisors),

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<sup>39</sup> The AMF is vested with the authority to grant their express approval (see articles 322-29 and 321-25 of the RGAMF). The Banking Commission has recognized rules of business conduct in accordance with article L. 613-1 of the *Code Monétaire et Financier*, without however conferring upon them the force of a regulation.

<sup>40</sup> As established practice.

- “professional conduct of business rules” approved by the Banking Commission and recognized as such by the Commission<sup>41</sup> (articles L 613-16 and L613-21 of the *Code Monétaire et Financier*)

Rules concerning the marketing of financial products that may be included in conduct of business rules approved by authorities naturally fall under this category. **Compliance monitoring procedures must consequently be extended to the distribution of these products** and a specific compliance function must be established in banking networks.

In this respect, the amended version of regulation 97-02 requires credit institutions and investment companies to create a compliance function as part of internal controls, reporting directly to the executive body. This function must include a person responsible for ensuring the coherence and effectiveness of compliance controls.

For investment service providers, this compliance function may be assigned to the person responsible for supervising investment services covered by articles 321-5 and 321-13 of the AMF General Regulation. This type of organization will also apply particularly to independent management companies.

Integrated firms should distinguish between **two areas of compliance monitoring**:

- **production**, notably responsible for ensuring compliance by the group management company or companies of their obligations as UCITS producers;
- **distribution**, responsible for ensuring compliance by the network of obligations imposed on distributors of banking, financial or insurance products, even though it is not advisable, at this level, to distinguish between types of products.

**In insurance companies**, compliance monitoring should be assured through **internal control procedures that must be strengthened and extended, through regulations**, to unlisted insurance companies,<sup>42</sup> pending the eventual introduction of the compliance function in the insurance sector by the adoption of a European directive in the still distant future. However, the same distinction should be made between controls applied to obligations by the company as a producer and controls of obligations by distributors, whether involving a network of salaried employees, general agents or insurance brokers.

In these different sectors, **internal controllers or compliance officers should focus in priority**:

- at the level of production, on profiling new products and ensuring compliance of marketing documents that may be used by distributors in relation to the characteristics of products as defined by contractual documents and ensuring that the producer provides distributors with training support for advisors-sales personnel on new products<sup>43</sup>;
- at the level of distribution, the preparation of marketing campaigns, monitoring training programs (to ensure that sellers have appropriate expertise

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<sup>41</sup> See for example the letter of May 15, 1990, concerning the AFEC recommendations on methods for marketing retirement savings plan (PEP) and the letter of June 10, 1991, concerning recommendations of the ASFFI on professional practices relating to UCITS.

<sup>42</sup> Insurance companies are in effect subject only to the existing rules on internal controls provided for only for listed companies.

<sup>43</sup> This would be especially easy in that regulation 97-02 expressly provides for associating the compliance officer with the granting of prior approval of new products. Similarly, the draft rules of the AMF on internal controls also provide that the compliance officer of management companies approves new products.

in the products they are authorized to sell) and the development of variable compensation systems and evaluating sales staff in the networks.

Compliance with rules of conduct imposed on producers and distributors of savings products, whether by law, regulations or professional conduct of business rules, must first be ensured by the internal control procedures of the establishments. This will in turn be naturally reinforced by external controls assured by regulators.

### **3.4. The role of regulators**

External controls of the different parties involved in marketing savings products in France are currently assured by three authorities: the Banking Commission for “banking” savings, the AMF for financial products and the CCAMIP for life insurance products.

These three authorities possess comparable powers to exercise controls, injunctions and sanctions that need to be harmonized. For marketing, their effectiveness could be strengthened by greater cooperation. One of them is able to issue recommendations or implement instructions that may under certain conditions be extended to the two others. Finally, consumer representation for these three authorities must be strengthened.

#### ***3.4.1. Harmonization of the powers to exercise controls, injunctions and sanctions of independent regulatory bodies***

In this area, few modifications of the current system are required.

Each of the three authorities has the power to:

- ensure that the establishments or undertakings under their jurisdiction comply with applicable laws and regulations;
- stop violations;
- sanction violations.

However, only the Banking Commission and the AMF are expressly vested with the power to **ensure compliance and sanction potential violations of conduct of business rules** that they have recognized or approved.

This power should be **extended by law to the French insurance industry regulator, the CCAMIP.**<sup>44</sup>

#### ***3.4.2. Strengthening cooperation between the three authorities***

Marketing savings products, especially in bank networks, is a global undertaking. The obligation to provide advice is meaningful only if accompanied by an effort to identify the product or products adapted to the customer’s needs and interests among all banking, financial and life insurance products available.

**The controls exercised over the marketing process must in consequence be comprehensive in nature.** However, such controls require the expertise of all three regulatory authorities: the CCAMIP for life insurance products, the AMF for financial products and the Banking Commission for banking products and to ensure that compliance monitoring procedures are coherently applied to retail banks.

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<sup>44</sup> For conduct of business rules approved according to the procedures described in 3.2.2.

These two seemingly contradictory requirements may be reconciled, however, by **strengthening cooperation between the three authorities**, along the lines of the cooperation already developed between the CCAMIP and the Banking Commission<sup>45</sup> on the one hand and between the AMF and the Banking Commission on the other hand.

In addition to exchanges of information between these authorities, already provided for under existing texts and widely applied, strengthened cooperation could take two forms that have already been successfully tested between the CCAMIP and the Banking Commission.

The first consists of **joint oversight of integrated firms**, particularly “bank-insurers.” This oversight could involve the combined participation of bank controllers, insurance commissioners and inspectors of the AMF, particularly for the marketing of savings products in retail banks, with each controlling those issues falling under its global authority, though in a coherent and coordinated manner. The Review recommends further cooperation, particularly in monitoring compliance of marketing documents, the conduct of marketing campaigns and due diligence obligations in providing advice.

These joint control procedures could also be usefully completed by jointly organizing **test purchases** of bank and financial products along the lines of the FSA in United Kingdom.

The second form of cooperation that should be pursued involves **joint studies and reviews of subjects of common interest**, relating to the resolution of potential regulatory problems that may result from differences in regulatory provisions that apply to different products and market participants.<sup>46</sup>

This reinforced cooperation concerning questions of marketing should be formalized through bilateral or trilateral agreements concluded between the chairmen of the three regulatory authorities and implemented notably through periodic meetings of their Secretary Generals.

### ***3.4.3. Extending to the CCAMIP and the Banking Commission powers to issue recommendations and implementation instructions***

In addition to its General Regulation, subject to approval by the French Ministry of Economy and Finance, the AMF is able to issue recommendations and develop implementation instructions. This ability is moreover merely the counterpart for independent authorities of the possibility widely recognized for administrations to offer clarifications to entities under their authority concerning the interpretation and application of laws and regulations by issuing circulars.

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<sup>45</sup> Agreement of October 24, 2001, between the Banking Commission and the CCAMIP.

<sup>46</sup> A study of this type, conducted by the Banking Commission and the CCA (*Commission de Contrôle des Assurances*), has indicated that financial groups tend to locate their guarantee in activity in insurance companies rather than credit institutions because the latter are subject to less stringent capital adequacy requirements. This practice was reported by the two French regulators to their European partners who despite the existence of common supervisory authorities did not discover this situation.

This ability, however, has been granted to the Banking Commission and the CCAMIP solely in respect to the development of a doctrine of administrative law concerning the missions vested upon them by lawmakers but not the interpretation of standards resulting from regulatory authorities or industry rules. Undertakings subject to the authority of the CCAMIP have moreover expressly contested this ability. Such a situation is untenable. If maintained, this would require decisions to resolve details concerning the interpretation and the application of texts be unnecessarily submitted for signature to the executive branch. It would moreover further increase the number of regulatory provisions in the French insurance code, which is already particularly voluminous

For this reason, it is proposed, without in any way limiting the regulatory authority of the executive branch, to **extend to the Banking Commission<sup>47</sup> and the CCAMIP the right granted to other authorities to issue recommendations and develop instructions for texts it is responsible for enforcing.**

#### **3.4.4. Better consumer representation for buyers of financial products with regulators**

The boards of the three authorities responsible for regulating or overseeing the financial sector all include representatives of public authorities and professionals in addition to, in the case of the AMF, individuals selected from among issuers and institutional investors and a representatives of employee shareholders.

This organization, which is natural for authorities responsible for exercising prudential oversight of undertakings or regulating financial markets, cannot address the foremost preoccupation of the retail investor or basic consumer, notably relating to the reasonable scope and methods of the marketing of financial products, particularly those that involve a high degree of risk and/or complexity.

The Review considers that the regulatory authorities should benefit from an **organization providing a voice to consumers** along the lines of the Financial Services Consumer Panel of the FSA in the United Kingdom for all financial and insurance products under their responsibility. This panel must be able to be **consulted by regulators**, notably concerning the suitability of marketing products characterized by their significant complexity and/or risk that may be subject to their authorization or approval (in the case of the AMF), or the suitability of the admission of these products in UCITS or in widely distributed unit-linked contracts (involving, in this latter case, products not subject to authorization though regulated). This body may also **refer to the competent authorities** on incidents that appear to constitute false or misleading advertising.

This role, which implies the participation of persons with a status of both retail investor or basic consumer and, if possible, possessing experience in the banking, financial and insurance sector, cannot be entirely assured today, given their scope of expertise and/or composition, nor by the advisory committee for the “protection of small investors and minority shareholders” included within the AMF only, nor by the CCSF (*Comité Consultatif du Secteur Financier*), the financial sector advisory committee, in its current form.

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<sup>47</sup> The Banking Commission will soon be required to render a decision on this matter, going beyond the simple individual cases for which it is currently able to issue warnings or injunctions on prudential issues within the framework of Basel II. In this respect, the possibility of issuing implementation instructions, without calling into question the regulatory powers of the minister, would enable it to offer such clarifications.



It is consequently proposed to consider the creation of a subcommittee of the advisory committee specialized in problems relating to the marketing of financial and insurance products. According to procedures to be defined, it could be associated with the AMF committee for the “protection of small investors and minority shareholders.”

## **CONCLUSIONS**

In conclusion, we are aware that we have begun rather than completed a project that the mission letter of the French Minister of the Economy, Finance and Industry rightly noted constitutes a highly complex undertaking. A number of points remain to be further examined, clarified or resolved. The essential achievement has been opening areas for further examination and action in a field that has until now only just started to be explored.

In this respect, we believe the proposals of this report will contribute to improvements in existing practices of marketing savings products which, while not as catastrophic as certain excesses registered notably in 1999-2002 might suggest, still do not sufficiently meet the challenges posed by the increasing transfer of savings and retirement-preparation risks and responsibility to households. This in turn implies the need for progress by financial intermediaries in fulfilling their obligations to provide information and advice.

These proposals are issued at a time when a large majority of establishments in the different sectors concerned are aware of the need for these improvements. Some of them have already implemented measures to this purpose and all of them today possess the financial resources to finance the investments in information technology and human resources necessary to achieve these objectives.

However, the scope and difficulty of this undertaking must not be minimized and, citing the image invoked by the chairman of a major banking group, it will inevitably encounter “a certain degree of resistance” in response to the strong character of line management and will require, in many respects, changes in the corporate culture of many establishments.

For this reason, we propose to work closely with the undertakings, through their professional organizations, inviting them to adhere to best practices identified by the Review in the course of consultations it has carried out and set forth in conduct of business rules approved by the public authority.

However, this will also require a strong commitment by public authorities, which must maintain, along with their European Community counterparts, a fair balance between the legitimate preoccupation to safeguard the competitiveness of the financial industry and the need to guarantee consumer protection. Only at this price will we succeed in securing the support of the latter in achieving a major European market of financial services, which is an indispensable condition for its success.

THE MINISTER OF THE ECONOMY,  
FINANCE AND INDUSTRY

Paris, April 6, 2005

Mr. Jacques Delmas-Marsalet  
Honorary Chairman of the Banques Populaires Group  
Member of the Constituency Board of the Financial Markets Authority  
(Autorité des Marchés Financiers)  
Office 534  
Autorité des Marchés Financiers  
17, place de la Bourse  
75082 Paris Cedex 2

Dear Mr. Chairman,

A number of recent events, including occurrences of the misselling of securities, the implementation of a number of European Union directives concerning insurance intermediaries and distance marketing of financial services, and of regulations covering financial investment advisers (Fr: CIFs), open clear and recurrent questions concerning the supervision and harmonization of methods of marketing financial products.

At its last meeting, the Committee of Finance Industry Supervisory Authorities (Comité des Autorités de Contrôle des Entreprises du Secteur Financier – CACES) asked that a person be chosen to study how to warn of the risks involved in the misselling of financial products and how to move towards a coherent and harmonized organization of securities marketing. Given your vast professional experience in all of the areas concerned, I am most pleased to request that you lead this complex project.

This study mission would cover savings products (passbook savings accounts, UCITS, life-insurance/capitalization policies, real-estate trusts), as well as other financial products that are marketed in connection with savings products. Particular emphasis should be given to the following points, with a view to harmonizing control by product and channel of distribution:

- Quality of information: The growing complexity of investment products has also led to voluminous contract documents that are barely readable to the great majority of savers, which means that the information they really receive comes from advertising. It would therefore appear indispensable to reflect on how savers could efficiently be provided with information enabling them to understand the characteristics of financial products;
- Quality advice, matching the products suggested with the client's needs and situation;
- A clarification of the respective responsibilities of distributors and producers of these products;
- Adaptation, when necessary, of the powers of the supervisory authorities to changes in marketing rules.

The authorities expect that this mission would include an analysis of the difficulties encountered on these various points, and of possible technical and legal improvements. To this end, you may set up a working group including representatives of the various supervisory authorities in the finance industry, as well as the chair of the financial industry's consultative committee (Comité consultatif du secteur financier), who has been informed of your mission; you may also undertake the consultations you consider necessary for the success of the project.

It would be best for your report to be submitted in the fall of 2005, in order to that any resulting needs changes in legislation to be included in draft legislation in good time. I also intend for this report is intended to be published. In order to meet these goals, I have asked that the Treasury and Economic Policy General Directorate, in liaison with the Finance Inspectorate (FR: Direction Générale du Trésor et de la Politique Economique, Inspection Générale des Finances, respectively) provide you with a full-time rapporteur and that the supervisory authorities of the finance industry provide you with all necessary support.

I would be grateful if you were to keep CACES informed of the progress made in your work. You may also contact them at any time in case you encounter difficulties in accomplishing your mission.

Sincerely yours,

Thierry Breton

**APPENDIX II**  
**WORKING GROUP MEMBERSHIP**

Jacques Delmas-Marsalet, member of the AMF board, chairman of the working group.

Mr. Macron, Inspector of Finances, Finance Inspectorate, rapporteur.

**Working Group Secretariat:**

Mr. Oseredczuk, project chief, office of the director of the department of regulation and international affairs (DRAI) at the Financial Markets Authority (AMF),

Mr. Stévant, project chief at the DRAI

**Working group members:**

**- Finance Industry Sector Advisory Committee:**

Mr. Constans, chairman of the finance industry advisory committee,

Ms. Houppert, Assistant Secretary General of the finance industry advisory committee.

**- Banking mediation committee:**

Mr. Vatin, Secretary of the banking mediation committee,

Ms. Peyret, Assistant Secretary of the banking mediation committee.

**- Banking commission:**

Mr. Tabourin, Head of the legal studies department at the Banking Commission.

**- Commission for the supervision of insurance companies and mutual insurance institutions (CCAMIP):**

Ms. Lemery, Member of the commission and chief, brigade chief,

Mr. Ruel, CCAMIP Secretary.

**- Directorate-General of the Treasury and Economic Policy (DGTPE):**

Mr. Lacresse, Chief, Office of savings and financial markets,

Mr. Alégret, Assistant chief, Office of savings and financial markets,

Mr. Jost, Chief, Office of markets and insurance products,

Mr. Gravier, Assistant chief, Office of markets and insurance products,

Mr. Cognat, Chief, Office of companies and insurance intermediaries

Mr. Irrman, Assistant chief, Office of companies and insurance intermediaries,

Mr. Sanson, Assistant chief, Office of banking and monetary affairs.

**- Financial Markets Authority (AMF):**

Ms. Guidoni, AMF mediator,

Ms. Yates, Service Chief, CEPIM (control of market service providers and infrastructures),

Ms. Colli-Patel, Deputy, Department of legal affairs, represented by Mr. Poubeau, project chief, department of legal affairs, and by Ms. Choquet, project chief, department of legal affairs.

Mr. Heilbronn (until July 31, 2005), then Mr. Macron (from July 31, 2005), Inspectors of Finance, Finance Inspectorate.

**APPENDIX III**  
**LIST OF INTERVIEWEES**

**I. RETAIL BANKING CHAINS AND PRIVATE BANKS:**

- Caisse Nationale des Caisses d'Epargne:	Mr. Mérindol,	Member of the executive board
	Mr. Pointillard,	Chairman of the executive board, Ecureuil Gestion (asset management).
- BNP Paribas:	Mr. Papiasse,	Director of Asset Management and Services (AMS), member of the executive committee of BNP Paribas AMS
	Ms. Korniloff,	AMS staff.
	Mr. Delooz,	Senior Vice-President, BNP-PAM (Asset Management)
	Mr. Monet,	BNP-P, Insurance.
	Mr. Pfister,	Vice-President for retail banking in France (BDDF), BNP-P (management of individual and business accounts).
	Mr. Volle,	Marketing chief, BNP-PAM.
- Crédit Mutuel:	Ms. Caffet,	Vice President for markets and business lines, Development Department, Confédération Nationale du Crédit Mutuel
	Mr. Martin,	Crédit Mutuel – Vie (Life insurance)
	Mr. de Buci	Crédit Mutuel - CIC Asset Management.
- Société Générale:	Mr. Sautter,	Vice President
	Mr. Berthon,	Senior Vice-President for private banking.

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	Mr. Dubois,	Senior Vice-President, LYXOR AM.
	Mr. Lacroix,	Senior Vice President for markets and business lines, SOGECAP (life insurance, capitalization)
	Mr. Wehry,	Senior Vice President for marketing, SGAM (asset management).
- Crédit Agricole:	Mr. Pauget,	Managing Director of Crédit Agricole S.A. and of Crédit Lyonnais.
	Mr. de la Porte du Theil,	Managing Director CAAM (asset management).
	Mr. Villatte,	Managing Director, Prédica (personal insurance, life insurance).
- Compagnie financière Edmond de Rothschild :	Mr. Giscard d'Estaing,	Senior Vice President, private banking and asset management.

### II. TRADING PLATFORMS:

- Boursorama:	Mr. Prin,	Senior Vice President, Communications.
	Mr. Vaugia,	Senior Vice President, Legal affairs.
	Mr. Taupin,	Managing Director.
- Rothschild et Compagnie Gestion (Asset management):	Mr. Bito,	Managing partner.
	Mr. Chevrier,	Manager.

### III. INSURANCE COMPANIES

- AXA:	Mr. Lejeune,	Senior Vice President, North East.
	Mr. Rouquayrol de Boisse,	Senior Vice President, legal and tax affairs.
	Mr. Royer,	Senior Vice President, audit department.
	Mr. Bernardi,	Senior Vice President.
- AGF:	Mr. Mignon,	Managing Director, member of the executive committee in charge of life insurance and financial services.
	Mr. Bernard,	Member of the senior management committee, Senior Vice President for employee programs

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	Mr. Brac de la Perrière,	Member of the senior management committee, Chairman of the executive board of AGF Asset Management.
	Mr. Caba,	Member of the senior management committee, Managing Director of AGF banque.
	Mr. Doubrovine,	Member of the senior management committee, Vice President for life-insurance products.
	Mr. Labrosse,	Member of the senior management committee, Senior Vice President for brokers, partnerships and independent asset managers.
	Ms. Lemoine,	Member of the senior management committee, Senior Vice President for management and strategic marketing, life insurance and financial services divisions.
	Mr. Thalassinos,	Senior Vice President, audit and quality control, life insurance and financial services divisions.
- Mutavie:	Mr. Challet,	Managing Director.
	Mr. Cuniot	Vice President for marketing and communications
	Mr. Desrus	Senior Vice President for network development and policy holders.

**IV. ASSET MANAGEMENT COMPANIES**

- Oddo Asset Management:	Philippe Oddo,	Chairman of the Supervisory Board.
- Fidelity:	Mr. Mercier,	Chairman
	Ms. Chapelain,	Ethics officer.
	Mr. Monème,	Senior Vice President for Communications.
	Ms. Gosserez,	Senior Vice President, legal affairs.
- Edmond de Rothschild asset management :	Mr. De Charry	Senior Vice President for development.
	Mr. Boulanger,	Senior Vice President for finance and administration.



### **- Report on the marketing of financial products. Appendix III-**

- Vanguard Investment Europe:	Mr. Prache,	Managing director.
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#### **V. ASSOCIATIONS PROFESSIONNELLES**

- French Banking Federation (FBF):	Mr. Prot,	Chairman
	Ms. Obolensky,	Managing director.
	Mr. de Lauzun,	Deputy Managing Director.
	Mr. Jolivet,	FBF Mediator.
	Mr. Tricou,	Senior Vice President

- Association Française de Gestion – AFG (Professional association of third-party asset managers):	Mr. Leclair,	Chairman.
	Mr. Bollon,	Managing director.
	Mr. Vlailor,	Deputy Managing Director.
	Ms. Chauprade,	Staff officer

- Fédération Française des Sociétés d'Assurance - FFSA (French federation of insurance companies):	Mr. de La Martinière,	Chairman.
	Mr. Boyer,	Managing director.
	Gilles Cossic	Senior Vice President for personal insurance.
	Philippe Poiget	Department of legal and tax affairs and competition.
	Mr. Frizon,	FBF Mediator.

### - Report on the marketing of financial products. Appendix III-

- Groupement des entreprises mutuelles d'assurances – GEMA (Association, of mutual insurance companies)	Mr. de Boissieu,	Secretary-General.
	Mr. Bonnet,	Chief of life insurance and finance.
	Mr. Durry,	GEMA Mediator
- Fédération Française des Courtiers d'Assurances et de Réassurances – FCA (French federation of insurance and reinsurance agents):	Mr. Leblanc,	Chairman.
	Mr. Lesage,	Managing director
	Mr. Pardessus,	Chairman of the legal and tax committee.
	Mr. Coutin,	Vice President for legal affairs.
- Association professionnelle des Sociétés Civiles de Placement Immobilier - ASPIM: (Association of real-estate investment trusts – REITs)	Mr. Brochard,	Chairman.
- French Association of Securities Professionals (AFTI) :	Mr. Roncin,	Chairman.
	Mr. Prigent,	Member.
- Association Professionnelle de l'Epargne Retraite – APFEN (Professional association of retirement insurance groups:	Mr. Vandier,	Managing director.
- Chambre des Indépendants du Patrimoine (Professional association of independent asset managers):	Mr. Olivier Colin,	Chairman.

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	Ms. Delphine Slanowski,	Managing director.
- Association des Porteurs de Parts SCPI - (Association of shareholders in REITs and similar assets :	Mr. Bonfil-Praire,	Chairman.
- Association française des Conseils en gestion de patrimoine certifié – CGPC (French association of certified asset managers):	Mr. Bensoussan,	Chairman.
	Mr. Rondeau,	Secretary-General.
- Association Nationale des Conseils Diplômés en Gestion du Patrimoine - ANCDGP: (Association of investment advisers with graduate degrees in asset management)	Mr. Foucher,	Chairman.
	Mr. de Salins,	Vice President.
	Mr. Loizelet,	Secretary-General.
- French Association of Investment Firms (AFEI) :	Mr. Delauzun,	Managing director.
	Mr. de Saint Mars,	Deputy managing director.

**VI. CONSUMERS AND INVESTORS' ASSOCIATIONS**

- Fédération des Associations Indépendantes de Défense des Epargnants pour la Retraite - FAIDER: (Federation of associations of members of retirement plans)	Mr. Perrin Pelletier,	President.
Familles rurales:	Mr. Bouget,	Staff officer

### **- Report on the marketing of financial products. Appendix III-**

- UFC Que Choisir (Consumers association):	Mr. Roullet,	Director
	Ms. Perez,	Chairperson of the banks and finance committee
- Testé pour Vous (Consumers organization specialized in financial products) :	Ms. Morin,	Senior Vice President
	Mr. Eon,	Technical editor, responsible for testing methods
	Ms. Lhotellerie,	Savings and insurance analyst
- Consommation - Logement Cadre de Vie – CLCV (Consumers association, all aspects of housing and daily life):	Ms. Mader,	Chairperson
- Association Française des Usagers des Banques – AFUB (Association of individual and SME consumers of banking and credit services):	Mr. Maître,	Secretary-General

### **VII. QUALIFIED PERSONS**

- France Info (radio station):	Mr. de Witt,	Journalist and member of the AMF's committee for savers and minority shareholders
- Elsewhere:	Mr. Labatte,	Consultant.
- BIPE (Economic forecasting):	Mr. Babeau,	Economist.
- Paris Bar Association:	Maître Daniel Richard,	Lawyer

**APPENDIX IV**  
**THE COMPOSITION OF HOUSEHOLD SAVINGS IN**  
**FRANCE AND CHANNELS FOR THE DISTRIBUTION**  
**OF SAVINGS VEHICLES**

**I. KEY TRENDS IN THE FINANCIAL ASSETS OF FRENCH HOUSEHOLDS**

The table below shows how the breakdown of financial assets held by French households has evolved since 1990.

Table 1: Breakdown of households' financial assets (exclusive of unlisted shares and other forms of ownership in companies).

Asset category	1990 (in %)	2000 (in %)	2004 (in %)
Short-term bank deposits and government-supported savings schemes ( PEL and PEP accounts with banks)	53.3	42.3	41.0
Direct holdings of securities	15.0	8.9	5.6
UCITS: Money market funds	8.6	1.9	1.9
UCITS: long term	9.1	12.4	10.2
Life insurance	14.0	34.5	41.3
Total	100.0	100.0	100.0

*Source: Banque de France*

Over the period examined, the most important trend in household savings was the increased proportion of investment risk held by households, as witnessed by a **decline in savings held in banks** (on which the latter carry the related risks) of over 10 points, and by an **increase in assets held in life-insurance policies**. In this context, it is important to distinguish between guaranteed-capital policies ("policies in euros") and policies permitting investment in equity-based products ("unit-linked policies"), the latter representing a transfer of market risk to households.

Tableau 2: Trends in the share of "unit-linked" assets in technical reserves

	1995	2000	2003	2004
Share of "unit-linked" policies (%) in technical reserves	8.8	20.2	16.0	17.7

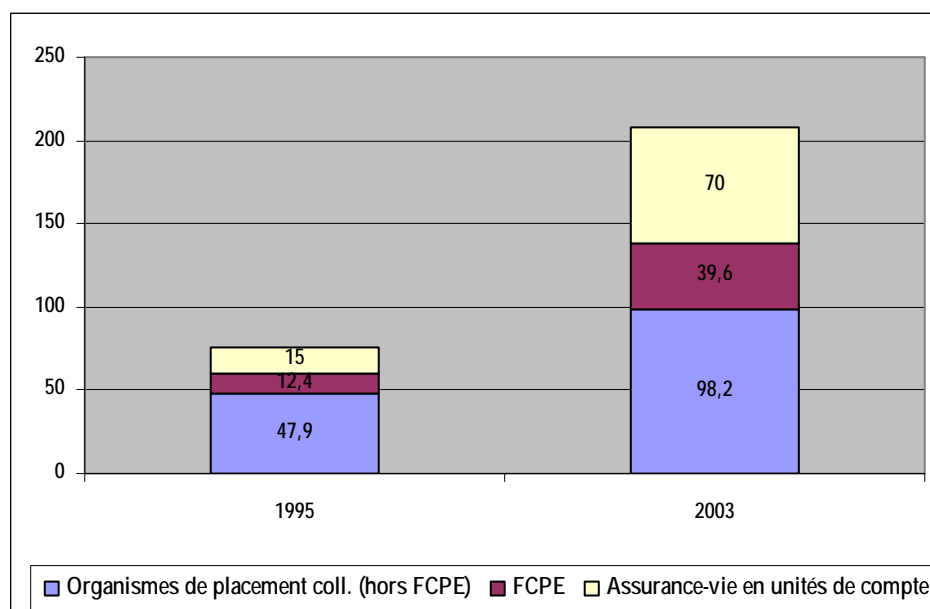
*Source: FFSA*

The trend is for **“unit-linked” products to take an increasing share in households’ financial savings**. If the bursting of the equities bubble at end-2000 logically led to a three-year decline in these investments (See Appendix V), subscriptions have been rising again since 2003. This is confirmed by the 14% increase in contributions to all life-insurance products **in the first nine months of 2005**, spurred by a **48% increase in contributions to “unit-linked” funds** (while contributions to “euro-linked” funds increased by only 7% (Source: FFSA, 2005).

It should also be noted that an increasing portion of savings is channelled through financial intermediaries. Hence, in 2004, 51.8%<sup>1</sup> of households’ financial assets were placed with institutional investors. Among OECD countries, only the United Kingdom has a higher rate of financial intermediation, at 60.7%<sup>2</sup>).

This means that **indirect shareholdings** of French households have dramatically increased over ten years, as is shown in the chart below.

Chart 1: Indirect shareholdings of French households (in billions of euros)



*Sources: Banque de France, FFSA, AMF.*

**Translation of Caption:** Investment funds (excluding employee savings), Employee savings funds (FCPE), “Unit-linked” life-insurance products

The most recent period has hence been characterized by disintermediation on the one hand and an increased role played by institutional investors on the other, a trend which has increasingly **transferred both investment risk and responsibility for choosing an investment portfolio to households**.

## **II. CHARACTERISTICS OF THE SYSTEM OF DISTRIBUTION OF FINANCIAL PRODUCTS IN FRANCE**

Many different players take part in marketing financial products in France, including:

<sup>1</sup> Source : Banque de France, AMF analysis, Studies department, 2005.

<sup>2</sup> Ibid.

**- Report on the marketing of financial products. Appendix IV -**

- integrated retail banking chains,
- financial investment advisers (Fr: CIF),
- insurance companies working with a salaried sales force and general insurance agents,
- insurance brokers,
- other professions that may have a secondary activity in selling financial products, such as notaries, CPAs, real-estate agents, etc.) ,
- Websites that enable individual investors or investment advisers to buy (or offer to sell) financial products.

The principal characteristic of the marketing of financial products in France is the preponderant position of integrated branch retail banking, as shown in the table below.

Table 3: Principal channels for the sale of financial products in France

<b>Financial product</b>	<b>Percentage sold by integrated branch retail banking</b>	<b>Percentage sold by independent entities (investment advisers, brokers)</b>	<b>Percentage sold by employees of insurance companies and general insurance agents</b>	<b>Percentage in direct sales or other channels</b>
UCITS	82 %	5 %	9 %	4 %
Life-insurance policies	62 %	10 %	23 %	5 %

*Sources: BCG Study, 2003/ FFSA, 2004.*

In France, securities retailing is mainly done by banks and, to a lesser extent, insurance companies. Conversely, in English-speaking countries, most retail sales are through independent investment advisers or broker-dealers.

**APPENDIX**

**V**

**STATISTICS ON THE PROCYCLICAL NATURE OF  
HOUSEHOLDS' PURCHASES OF FINANCIAL PRODUCTS**

This appendix highlights and describes the procyclical character of households' purchases of financial products by observing the trend in sales of products of real-estate investment trusts, direct and indirect investments in equities and insurance policies permitting investment in equity-based products ("unit-linked contracts), as they relate to the market prices of the assets purchased or the policies subscribed to.

**I. REAL-ESTATE INVESTMENT TRUSTS (REITs)**

**1.1. Statistics on the prices of real estate prices and of REITs**

For purposes of this analysis, we have compared long-term statistics on real estate prices and the net annual value of purchases of shares in REITs.

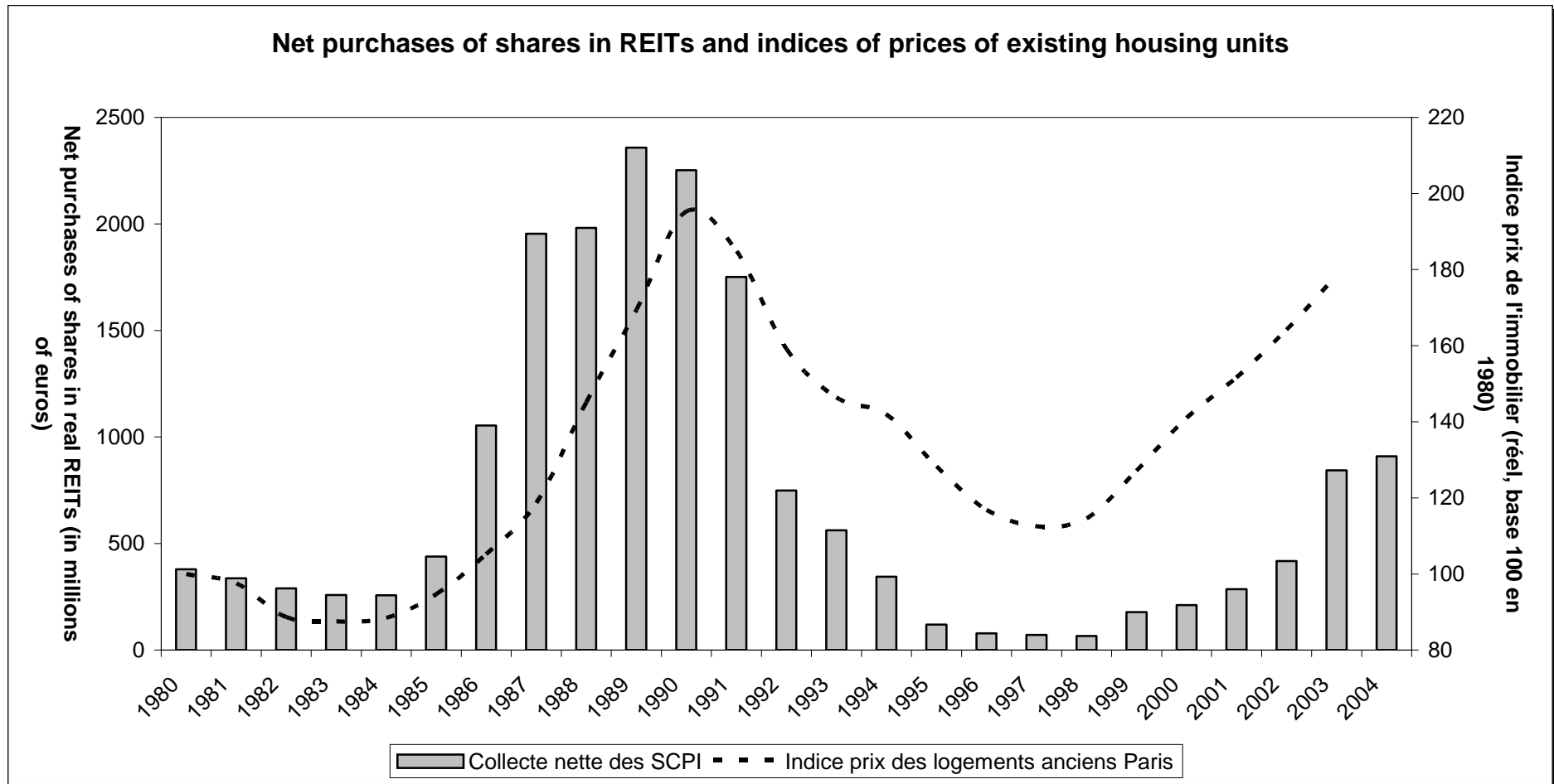
Concerning the index of real-estate values, a study by the Banque de France<sup>1</sup> recalls that: "retrospective analysis of real-estate prices is hampered by the lack of consistent sets of figures for France prior to 1994. Nonetheless, to provide a representative set of figures, [the study] developed a set of figures on the price of existing housing units beginning in 1980, using data supplied by the National Federation of Real-estate Agents (FNAIM) for the period prior to 1994. Moreover, a technically consistent set of figures from the National Institute of Statistics (INSEE) is available for the Paris real-estate market for the period 1980-2004." These are the indices referred to here. Data have been adjusted for inflation in order to make them more representative over the long term. The base of 100 applies to figures for 1980.

The statistics on annual purchases of shares in REITs are obtained from the monthly report of the COB and its successor as France's market regulator, the AMF (Autorité des marchés Financiers - Financial Markets Authority). These are based on reports made by asset managers, likewise adjusted for inflation and expressed in 2004 euros.

The chart below shows the trend in sales of shares in REITs from 1980 to 2004.

<sup>1</sup> *Y a-t-il un risque de bulle immobilière en France ?*, Bulletin of the Banque de France, No. 129, September 2004





**Traduction du legende :** Net purchases of shares in REITs ; Price index: Existing housing in Paris  
**Sources:** Banque de France (according to INSEE and FNAIM), AMF

## 1.2. Brief analysis of the data

Trends in the real-estate index are clearly explained in the Banque de France study mentioned above. They show a real-estate bubble in Paris that burst in 1990, while prices remained relatively stable in the rest of France. More recently, since 1999, there has been a steep increase in real estate prices in real terms in all of France.

Net inflows into REITs remained positive throughout the period 1980–2004, i.e., new subscriptions were always at a higher level than redemptions of shares. Real estate values strongly influence household attitudes towards REITs: After a long period of stability in net inflows (new subscriptions averaged 320 million euros per year in real terms between 1974 and 1984), the development of the Paris real-estate bubble from 1986 to 1990 was clearly mirrored in a wave of new subscriptions. During a period in which Paris real-estate prices doubled, annual subscriptions to REITs increased nine-fold; the high-point was 1989, at 2.358 billion euros. As the balloon deflated markedly between 1991 and 1998, inflows into REITs also showed down substantially, touching a historic low of 65 million euros in 1998. The recovery in real-estate prices, this time nationwide, also led to a new increase in subscriptions to REITs; while prices of existing real-estate increased by some 40% nation-wide from 1998 to 2003, new money collected by REITs increased by 1200%.

**Household investment in REITs therefore shows a highly procyclical trend, tracking the evolution of real-estate prices.** The change in net inflows into REITs is clearly greater than the change in real-estate prices. One can assume that investors looked mainly at recent price increases in determining their choices among the various products offered them. It should be noted that the drop in households' interest in REITs happened well before the surge in equity prices at the end of the 1990s and the equity investment boom that went with it.

## II. EQUITIES AND FINANCIAL INSTRUMENTS COMPRISED MAINLY OF EQUITIES

### 2.1. Statistical data

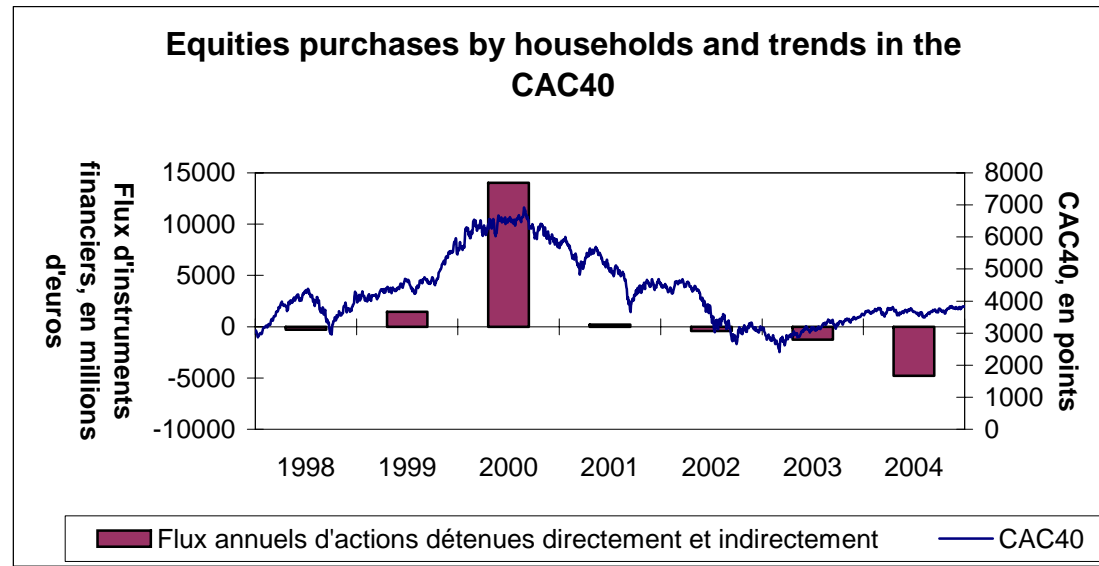
The index used to track equities markets is the CAC40, which is admittedly less representative than other indices based on a larger basket of stocks but is also best known to the general public.

<sup>2</sup> Source: Banque de France, UCITS tables and charts, France, Q4 2004, *Table 3: OPCVM actions - ventilation de l'actif net*, (moyenne de 1999 à 2004)

<sup>3</sup> Source : *ibid.*, *Tableau 4 : OPCVM diversifiés - ventilation de l'actif net*, (moyenne de 1999 à 2004)

<sup>4</sup> Source : *ibid.*, *Tableau 5 : OPCVM garantis - ventilation de l'actif net*, (moyenne de 1999 à 2004)

<sup>5</sup> *Placement en valeurs mobilières des agents économiques*, Banque de France, quarterly data examined from March 1998 to December 2004



**Legende :** Annual flow of equities held directly and indirectly ; CAC40

**Les axes :** **Gauche :** Flow of financial instruments in millions of euros ; **Droite :** CAC40 in points

**Sources :** Euronext and Banque de France

## 2.2. Brief analysis of the data

There is also a clearly observable pro-cyclical tendency in households' investments in equities. When the CAC40 rose sharply in 1999 and 2000, there was also a flow of funds into equities and equities-based UCITS. For example, there was a positive inflow of 14 billion euros in 2000, compared with 1.4 billion euros in 1999, covering a period in which the value of the CAC 40 doubled. By the same token, the drop in equities values marked a slowdown and then a reversal in UCITS investment between 2001 and 2003, with a small positive inflow of 210 million euros in 2001 turning to a net outflow of 1.3 billion euros in 2003.

This analysis is supported by an AMF study<sup>6</sup>, which points out that: “statistics on securities purchases over the entire stock market cycle show that households demonstrated largely pro-cyclical behavior, making massive purchases of equity-based products during periods of rising markets and cutting back demand for risky assets substantially during periods when stock prices were declining.”

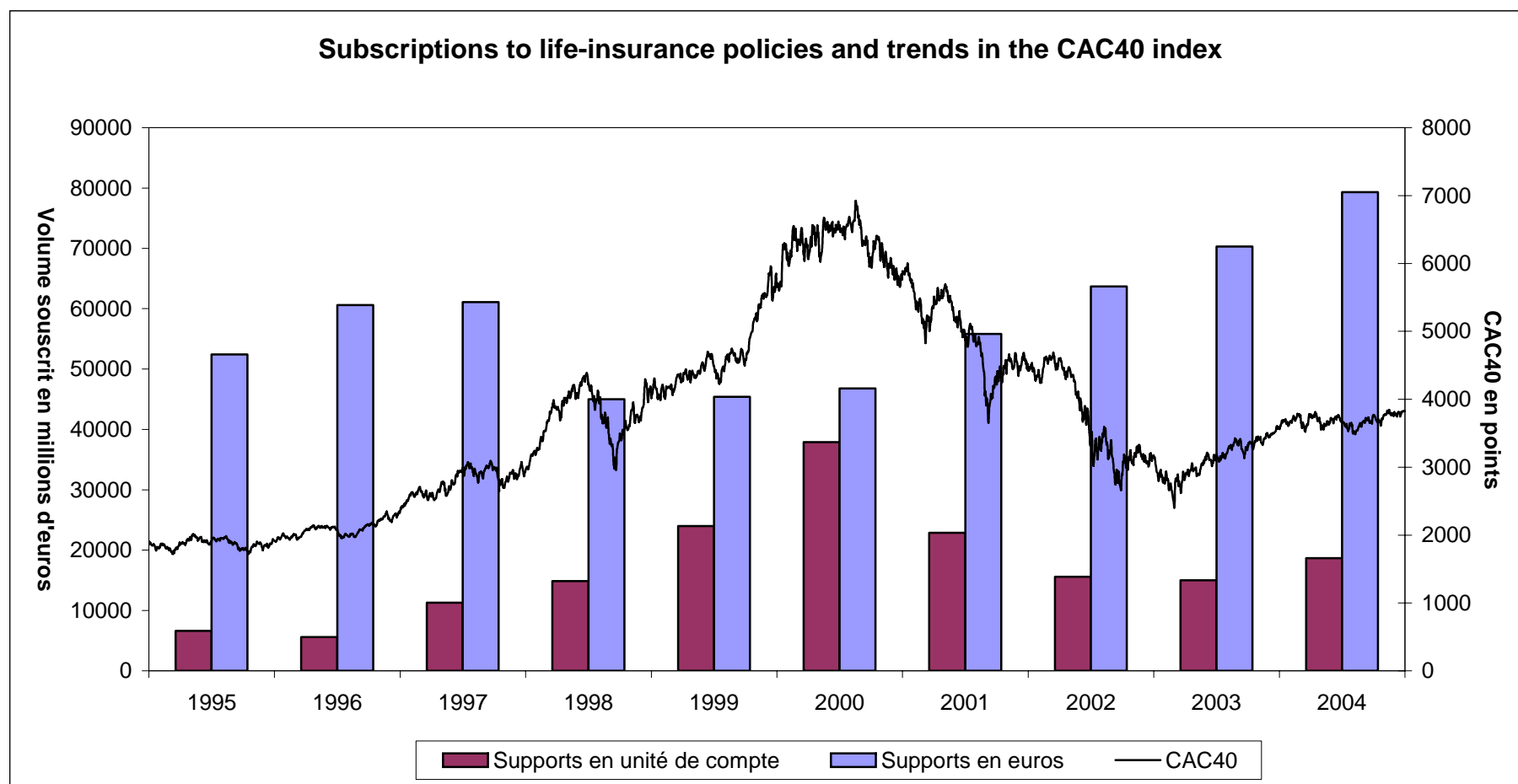
## III. LIFE-INSURANCE POLICIES

### 3.1. Statistical data

Statistical data on life-insurance policies have been supplied by French Federation of Insurance Companies (FFSA)<sup>7</sup>. These policies are investment instruments frequently used by households. The trend in annual subscriptions to such policies is examined here, in comparing policies permitting investments in equity-based products (“unit-linked” contracts), that are hence highly exposed to developments in equities markets, as opposed to those limited to fixed-income based (“euro-linked”) products, in which the capital is guaranteed.

<sup>6</sup> *Les tendances du patrimoine financier des ménages français*, Monthly review of the AMF, No.13, April 2005, p. 5

<sup>7</sup> FFSA, Annual report, 2004



**Legende :** “Unit-linked” ; policies “Euro-linked” policies ; CAC40  
**Les axes :** Subscription volume in millions of euros ; CAC40 in points  
**Sources:** FFSA and Euronext

### 3.2. Brief analysis of the data

The rise in subscriptions to life-insurance policies has been a pronounced trend in France for at least a dozen years. Hence, technical reserves to cover such contracts are constantly increasing. There is a twofold reason for this: on the one hand, a favorable tax regime serves as an incentive; on the other hand, households are increasing savings to prepare for retirement. This makes it interesting to compare the relative shares of subscriptions to “euro-linked” and “unit-linked” policies, since investors have to choose between the two.

In this analysis, a very clear correlation appears between trends in stock prices and the choices between the two types of policies. “Unit-linked” policies accounted for 8.5% of subscriptions in 1996, 45% in 2000 and 17.5% in 2003. The variation is quite pronounced, and demonstrates the pro-cyclical behavior of investors. Even though the investments involved are long-term, households appear to be strongly influenced by market performance in the most recent past, as provided them by both their investment advisor and the specialized press.

\*

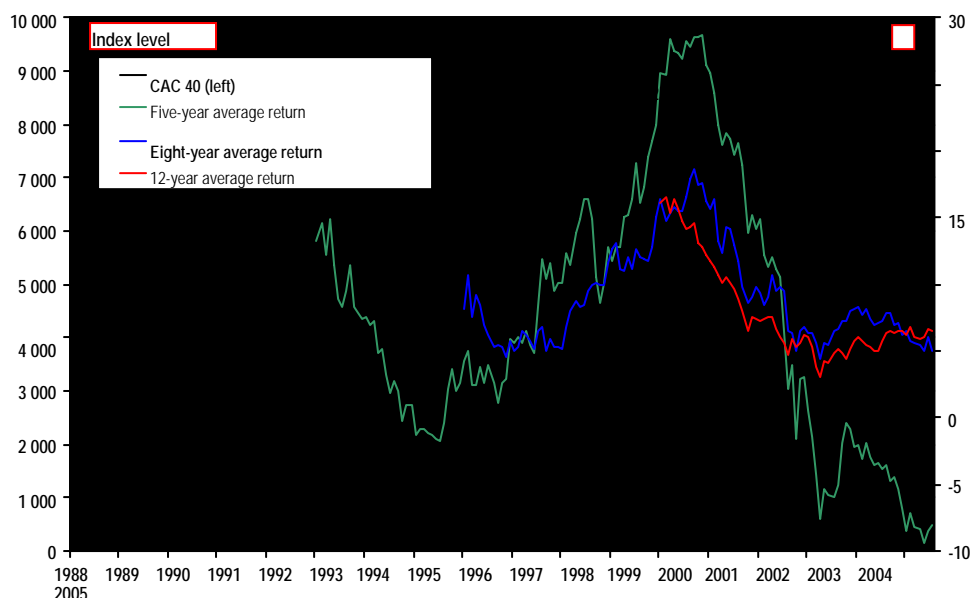
\*      \*

In analyzing these different financial instruments, it becomes quite clear that households’ choices among different investments are often conditioned by short-term trends in equity indices, whether positive or negative. In effect, investors **seem to be particularly influenced by the recent performance of the various products, even though most of these are intended as long-term investment vehicles.** Hence, the profile of household investments closely traces market trends, and indeed amplifies them. **The consequence of this is that the majority of households buys at the very end of a market cycle** instead of selling, and hence never make the hoped-for capital gains. In effect, they find themselves owners of securities that are under priced when the market moves into decline.

**APPENDIX**  
**VI**  
**STATISTICAL DATA ON RECOMMENDED**  
**INVESTMENT PERIOD**

This Review has examined the CAC 40 index's average annual return since launch based on five, eight and 12-year moving averages. The data, not corrected for inflation, is shown in the following chart:

**Nominal CAC 40 return using moving averages**



Sources: AMF, surveys

The results demonstrate that longer investment holding periods reduce the risk of losses.

An **INSEE study** of stocks, bonds and gold for the 1951-2000 period highlighted the following:

**Expected gains and return volatility by holding period,**  
**1951-2000** %

		1 Yr	5 Yr	10 Yr	30 Yr
<b>Stocks</b>	Expected gain (average return)	<b>8.6</b>	<b>7.3</b>	<b>6.2</b>	<b>5.5</b>
	Volatility (return standard deviation)	21.5	9.3	6.5	1.7
	Probability of return	<b>65.3</b>	<b>77.8</b>	<b>75.0</b>	<b>100.0</b>
<b>Bonds</b>	Expected gain (average return)	<b>4.9</b>	<b>4.7</b>	<b>4.7</b>	<b>4.4</b>
	Volatility (return standard deviation)	6.1	3.7	3.4	1.2
	Probability of return	<b>77.6</b>	<b>88.9</b>	<b>100.0</b>	<b>100.0</b>
<b>Gold</b>	Expected gain (average return)	<b>(-0.1)</b>	<b>0.2</b>	<b>0.6</b>	<b>2.2</b>
	Volatility (return standard deviation)	17.8	8.1	6.7	0.8
	Probability of return	<b>40.8</b>	<b>33.3</b>	<b>42.5</b>	<b>100.0</b>

Source: INSEE Première, n°827, February 2002.

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The historical data shows that the probability of a positive return increases in line with the length of the holding period. This confirmed the outcome from the initial analysis using moving averages.

A third study carried out by the Association Française de Gestion (AFG) also supports this finding. Covering the 1969-2001 period, it gives the following results after correcting for inflation:

### Real returns and probability of gains/losses (CAC 40)

1969-2005	Investment period				
	1 yr	8 yr	15 yr	20 yr	30 yr
Average annualized return	5.1%	5.2% 6.6%	7.2%	5.7%	
- o/w maximum gain	(+82%)	(+20%)	(+13%)	(+13%)	(+7.3%)
- o/w maximum loss	(-50%)	(-12%)	(-1.6%)	(+2.9%)	(+3.0%)
Range (gain-loss)	132%	32%	14.9%	10.1%	4.3%
Probability of gains	58%	76%	95%	100%	100%

Sources: AFG, C. Parđo.

As with the two previous studies, the AFG results demonstrate that the probability of investment gains increases sharply in relation to the length of the holding period.

The three outcomes confirm that longer investment periods reduce the risk of losses, even though the longer holding period also decreases the chance of generating a particularly high gain. Though highly convincing, it is important to emphasize that medium- and long-term past performance cannot be used as an indicator for the CAC 40's medium- and long-term future trend.