Deutscher Derivate Verband

3 August 2021

Public consultation on a retail investment strategy for Europe

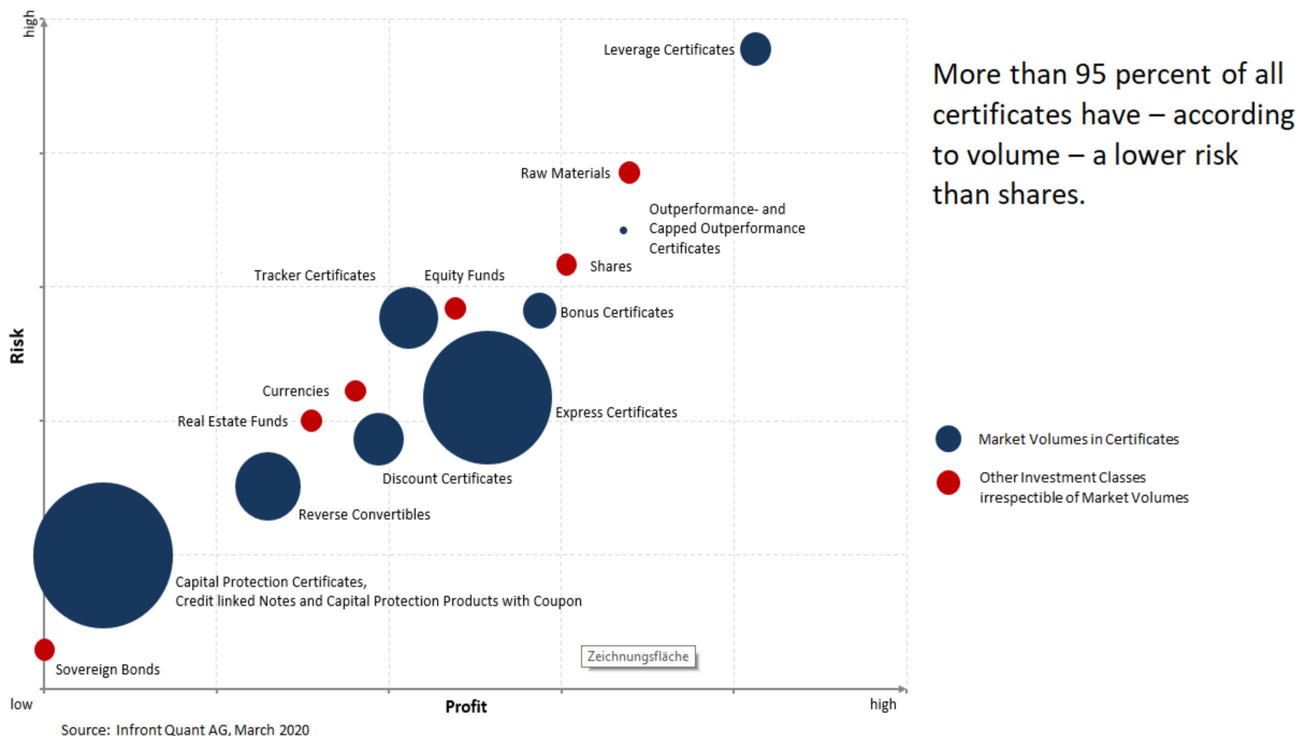
Additional information

In relation to Q 1.1:

With regards to the diversification of products at the disposal of investors, DDV members endeavour to issue a variety of tailor-made products, which can be divided into 12 categories according to the DDV classification:

https://www.derivateverband.de/MediaLibrary/Document/Derivate-Liga_A3_2020_EN.pdf

These products range from Uncapped Capital Protection Certificates to Knock-out Warrants. More than one third of these products offer capital protection. In addition, as the following figure illustrates, 95 percent of issued structured products (according to volume) have a lower risk than plain vanilla shares. This means that structured products (due to full or partial capital protection) also provide investment options to those investors who are interested in investing in shares but do not wish to bear the full risk. In a nutshell, the products issued by DDV members aim to contribute to the diversification of investment portfolios and attract private investors, due to their higher return capacity or risk-adjusted returns (depending on their structure).



The Deutscher Derivate Verband (DDV, German Derivatives Association) is the industry body which represents the 15 leading issuers of structured securities with a market share of more than 90 percent in Germany. Its work is supported by 17 sponsoring members, amongst which are exchanges and direct banks. Based in Berlin, Frankfurt and Brussels, the DDV has the mandate to elaborate self-regulatory standards such as the Fairness Code which is observed by the issuers with respect to the structuring, issuing, marketing and trading of structured products. Transparency and education of retail investors is at the heart of its mission. For more information, please consult www.derivateverband.de.

Furthermore, these products create a pull-factor on the markets for the full range of investments at the disposal of the investor. In other words, once the investors are on the markets, their appetite to trade is whetted. For instance, leverage products is the sixth category invested in by investors, which means that they invest in shares, funds, etc. prior to investing in leverage products.

In relation to Q 2.2:

Further to the aforementioned initiatives, training has been set up for more advanced investors on structured products with three consecutive levels, available online. Investors also have credit ratings at their disposal to help them assess the creditworthiness of issuers.

Moreover events are organised, such as the German Derivatives Day (organised in Frankfurt every autumn, which presents an opportunity for issuers, politicians, and journalists from Germany and the rest of Europe to come together) and the DDV Business Journalism Award (held in Stuttgart every year, which recognises outstanding writing on structured products).

The DDV has been working a lot on improving transparency as illustrated by the Fairness Code that ties the industry to standards above and beyond the regulatory framework. This code contains important rules in order to ensure trust between the issuers of structured products and retail investors, which all members of the DDV have committed to observe. More recently, with the development of a Sustainable Finance Code of Conduct, the DDV has contributed to fostering sustainability literacy. It aims to fulfil the need of the structured securities industry in Germany for transparent, clear, and uniform standards, which are crucial for the comprehensibility and the comparability of sustainable investments from an investor perspective.

The ultimate objective of these initiatives is to increase trust and knowledge which are sine qua non conditions for more investment in financial products.

In relation to Q 9.1:

A reflection around complexity implies to look back at the approaches that have been taken so far, in particular in the regulatory and academic arenas.

As early as in 2012, IOSCO was particularly interested in exploring the market for retail structured products to understand the drivers for both supply-side (i.e., issuer and distributor) behaviour and demand-side (i.e., investor) behaviour. With respect to distribution, IOSCO published its Final Report Suitability Requirements with respect to the Distribution of Complex Financial Products in January 2013, thereby promoting robust customer protection in connection with the distribution of complex financial products by intermediaries. The Final Report defined “complex financial products” broadly

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and inclusive of “structured investments”[1]. The concept underlying IOSCO´s approach to complexity consisted in particular to not only focus on the complex structure of the financial products, but to also consider the retail customers´ understanding.

At EU level, the approach taken was to define “non-complex” (as opposed to “complex”) in Article 25(4) of MiFID II, further specified in Article 57 of the MiFID II Delegated Regulation(EU) 2017/565.

By adapting the concept “non-complex” in MiFID II, the European legislator did, however, not intend to introduce a new general (regulatory) category of “simple products”, but simply aimed to reduce the MiFID II regulatory requirements for investment firms that provide investment services consisting only of execution and/or of the reception and transmission of client orders in relation to “non-complex” financial instruments, without the need to obtain information regarding the knowledge and experience of the client in order to assess the appropriateness of the service or the financial instrument for the client. In fact, it should be kept in mind that the categorisation was introduced by MiFID II to reduce the MiFID regulatory requirements for investment firms – and not to establish, from a regulatory perspective, a distinct stand-alone category of “complex” investment products. Introducing such a distinction based on a notion of “simplicity” of investment products is, in our view, even likely to jeopardise the underlying legislative objectives (since it in particular reduced the range and diversity of investment products available to retail investors).

Against this background, we would take the view that the categorisation “complex”/”non-complex” as embedded in Article 25(4) of MiFID II, and for which ESMA provided further explanatory guidance, should currently only be applied in the context of determining MiFID II regulatory requirements regarding execution-only, but not as a blueprint for establishing various categories of investment products in general. In the future, further reflection may be needed (see below).

In addition, many of the relevant investor protection requirements, including again product governance and the conduct-related rules, already take into account differences between individual products through their “built-in” proportionality, which requires different kinds of safeguards or restrictions vis-à-vis target clients depending on the categorisation of products according to the mentioned criteria.

A quantitative and economic approach to the complexity of financial products may help shedding light on potential developments in the future. The level of investor protection in relation to a specific product required can only be determined cumulatively as a function of different factors. Among others, these factors include their relative degree of riskiness (including liquidity), degree of structuring, and transparency (understandability).

This assessment is confirmed by several academic studies that, in recent years, have tried to capture crucial aspects of complexity. Each of these studies accounts for different combinations and weighting

[1] "**Complex financial products**" refer to financial products, whose terms, features and risks are not reasonably likely to be understood by a retail customer (as that term is defined in individual jurisdictions) because of their complex structure (as opposed to more traditional or plain vanilla investment instruments), and which are also difficult to value (i.e., their valuations require specific skills and/or systems, particularly when there is a very limited or no secondary market). […] The term does not include conventional equities, conventional bonds, plain vanilla unit trusts and mutual funds and exchange-traded standardized derivatives contracts. […].

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of factors (such as simplicity of the payoff formula, the underlying, the risk profile, liquidity, and cost and fee structures). Some of these factors apply to different asset classes independent of their “wrapper”, however familiar the latter might be.

This view is supported by a study presented by Christian Koziol, Philipp Roßmann, and Sebastian Weitz (Complexity of Financial Products: a Quantitative and Economic Approach, Tübingen 2018), which proposes an economic approach for determining the complexity of financial instruments based on the notion of complexity from an investor’s perspective, along with a method aligned with that notion. On the basis of the "value-surprise" (the difference between an investor's estimation of the value of a financial product and its true value) they make estimates using capital market data in order to ultimately translate these value surprises into a consistent complexity scores.

In their economic approach, the authors aim to avoid any subjective weightings of individual product characteristics. In their view, the existing MiFID II classification is not at all consistent with the study’s results. According to the study, a classic discount certificate (“complex” according to MiFID II rules) would be less complex than an equity fund and much less complex than a life insurance policy (MiFID II: both considered to be “non-complex”). The least complex product is considered to be a 2-year German government bond (MiFID II: “non-complex”), a 10-year German government bond, however, would be more complex (MiFID II: “non-complex”) than a DAX future (MiFID II: “complex”). A non-traded corporate bond is considered to be one of the most complex products (MiFID II: “non-complex”).

In summary:

- There are major differences in complexity within individual asset classes:
    - Products like life insurance policies and investment funds (which are classified as non-complex in accordance with MiFID II) can prove to be particularly complex;
    - Non-complex products are not automatically safe and easy to understand, and complex products are not necessarily high risk;
    - A number of supposedly complex products turn out to be very user friendly;
    - Financial products that are traded on securities exchanges have the advantage that investors can find out at any time the price of the financial product.
- Greater complexity:
    - Results from a lack of transparency in portfolio composition (as is the case for life insurance policies and most actively managed funds);
    - Serves to provide protection against risks in some cases.
- Regulators may be inspired by the following recommendations:
    - The current definition of complexity should not be retained as a criterion for an investor´s purchase decision, as it can be counterproductive and misleading;
    - Complexity should not be sweepingly determined at the level of the product category;

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- The complexity of a financial product´s internal structure should not be equated with complexity of usage from the investor´s perspective;
- The investor´s conception of complexity should be put at the centre, as well as their experience of it;
- Effective investor protection should focus on the comprehensibility and transparency of financial products.

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