

Protecting investors in complex financial products – the Portuguese way

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The increasing level of complexity in products offered to retail investors has been one of the major developments in financial markets over the last few years in Portugal. When the 2008 banking crisis erupted, increasing losses on investments led to a growth in customer complaints, as investors sought to hold financial intermediaries liable for financial instruments which fell short of their expected performance. One argument repeatedly used by investors in this context related to the alleged obscurity and opaqueness of the information provided prior to subscription, especially where more complex products were involved. Further to the completeness and accuracy of information, the actual clarity of such information was being questioned by investors.

In response to this situation, Portuguese authorities attempted to create a new paradigm with regard to information to be provided to the average investor in complex financial products. The goal was to ensure that information included in complex financial products is always provided to prospective investors in a way that is both understandable to them and allows comparison between equivalent products offered by different financial institutions.

The result of these efforts was the enactment, between late 2008 and early 2009, of a specific framework for marketing complex financial products to non-qualified investors (as defined in the relevant EU Directives, which by then had been implemented in Portugal). The new rules apply to any financial instrument (as defined in MiFID) possessing characteristics not directly identifiable with those usually seen in instruments of the same class, notably by being linked to a specific underlying, such as stock, basket of stocks or an equity index, upon which performance they depend. This wide definition includes financial products such as structured notes (ex. ILN and ELN), certificates, detachable warrants and indexed deposits.

The main feature of this special framework is the obligation (imposing on the relevant distributor) to prepare and deliver to prospective investors in complex financial products an Informative Document which: (i) identifies the relevant product as a complex financial product; (ii) outlines the main risks of investing in such product; and (iii) provides a brief and clear description of how that product works, which must include examples with practical scenarios.

The need to present practical scenarios is a particularly interesting aspect of the Portuguese legal framework. Contrary to the abstract explanations usually found in prospectus and final terms, the Informative Documents must include a specific demonstration of the way in which changes to the underlying affect the relevant products' performance. For instance, the wording used in product descriptions in prospectuses or final terms is usually very similar to "Note X pays an annual 5 percent coupon provided that the value of the underlying asset does not devalue 10 percent between calculation dates, and will be redeemed at its nominal value on the final maturity date if the underlying does not fall below 75 percent of its value as at the issue date".

In addition to this abstract description, an Informative Document for distribution of Note X in Portugal would have to include a specific demonstration of what would happen in a given number of different scenarios to an investment of, for instance €1000 in Note X, should: (i) the underlying asset devalue 10 or 15 percent between calculation dates; or (ii) remain the same throughout most of the term of Note X but suffer a 30 percent decrease near maturity and fail to recover; or (iii) suffer the same 30 percent decrease and still recover prior to maturity; and so on. Considering the low level of financial literacy present in the great majority of the Portuguese population (evidenced by the results of a recent Bank of Portugal survey on the matter), the use of practical examples may indeed help customers to understand the product and

make sounder investment decisions.

The CMVM (the Portuguese securities supervisor) has been very active in analysing and imposing changes to Informative Documents submitted for approval, and the aforementioned practical scenarios usually deserve significant attention. Unlike what could be expected, the CMVM does not require many scenarios to be presented. It actually restrains the number of examples provided to somewhere between three (which is the ideal number, with a favourable, an unfavourable and a neutral scenario) and five, although Informative Documents for products affected by more variables may (and usually do) present more. This may be explained by a need for clarity before completeness. More than make prospective investors aware of every detail of the relevant product, the CMVM intends the Informative Document to briefly and clearly explain fundamentals and to allow investors to compare different products or equivalent products from different financial institutions. This focus on clarity and comparability is also reflected in other frequent issues addressed by the CMVM when analysing Informative Documents, such as the need to place the abstract description of the product on the first page, along with a separate text box alerting investors (with short, predefined expressions such as “Possible partial or total loss of investment”) to the main risks of investing in the relevant product.

The inclusion of practical scenarios in Informative Documents brought about a new issue: although it is now easier to assess how complex financial products are affected by changes in the value of the relevant underlying assets, investors still have no way to ponder in their decision-making process the fact that some scenarios are more likely to occur than others.

The CMVM began addressing this limitation by requiring that the main references to the practical scenarios in Informative Documents be accompanied by wording such as “which probability of occurrence is not necessarily equal”. However, it is believed that this will not be a permanent solution, at least not by itself, as the CMVM has been consulting with market players on how best to provide prospective investors with a way to assess the expected return on their investments. The expected result of this consultation is an amendment to the existing framework, requiring additional disclosure of information pertaining to the probability of each of the different scenarios set out in the Informative Documents.

Further to enacting the aforementioned framework, the CMVM has made significant efforts to provide information to prospective investors in complex financial products. It has done so by preparing and making available online an easy-to-use centralised database of complex financial products distributed in Portugal, each entry featuring the relevant Informative Document. It has also prepared and made available to the public a number of recommendations and advisory documents outlining the main risks of investing in complex financial products and the main precautions that the average investor should follow in this regard, as well as a glossary of financial language which is likely to be found in Informative Documents.

It is still too soon to judge the results of Portuguese policy in this field. So far, an obvious downside of the special framework has been the lack of specifications as to document structure and wording, leading to a lack of uniformity in the structure and contents of Informative Documents used by different financial institutions. As the CMVM is still in the process of building a uniform understanding as to what it should require in terms of structure and wording, Informative Documents are sometimes more different than would be justifiable by the actual differences between the products to which they refer. Discrepancies at this level could be corrected, or at least minimised, if a template of Informative Document would be adopted by the CMVM.

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