Mis-selling of Preferred Shares to Spanish Retail Clients

Fernando Zunzunegui*

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The issue

The financial crisis underscored the opportunistic performance of some banks that have taken advantage of the relationship of trust with their clients to sell them products that are not appropriate to their profile.[1] Retail investors lost money due to investments where risks were not transparent.[2]

In Spain, the sale of "preferred shares" (*participaciones preferentes*) in the branches of credit institutions to hundreds of thousands of clients has led to a huge problem.[3] These "shares" are a "complex and high risk instrument because the capital invested may be lost".[4] In spite of their complexity and risk, they were offered by credit institutions, mainly savings banks, as an alternative to sight deposits, without informing on their risks. Clients were never warned that it was a hazardous product that would make them vulnerable. With the lapse of time, this hazard was evidenced in the loss of value of the product market.

Clients, consumers of these high risk financial products, were surprised when discovering that what they considered a safe investment was threatening the principal of their savings, with the resulting loss of trust in the institutions that had set them in that position. Then, in addition to the problem for clients of seeing their savings threatened, there is a risk for institutions of losing their goodwill.

Most of the credit institutions issuing these products starting offering exchanges to their clients in order to give them an alternative that reduces losses and allows keeping a relationship with the clients. However, some institutions, specifically the ones rescued with public funds, had this solution prohibited.[5] This prohibition stems from the Memorandum of the European Commission dated July 24, 2012, which restricts the State aid to rescue Spanish banking to the taking of losses by the holders of preferred shares.[6]

In this article, we are going to identify the problem of the indiscriminate distribution of preferred shares to the clients of the branches of credit institutions.[7] Once the problem is identified, we will make a critical review of the legal framework applicable to the sale of preferred shares, in order to propose changes to improve the protection to investor. But these preventive measures do not solve the problem of those families that purchased preferred shares and which did not receive an exchange that compensates them appropriately. For this reason, we add a chapter dedicated to palliative measures that may be applied to provide a fair and equity solution to the more prejudiced clients. The report analyses and provides brief conclusions.

What is the problem?

This section discusses the analysis of the problem of selling preferred shares and we are going to start analysing the product before their sale.

Analysis of preferred shares

In order to understand what preferred shares are, it is appropriate to analyse what both Banco de España and Comisión Nacional del Mercado de Valores (CNMV) carried out with them before the crisis. The long quotes we are going to insert are justified because they illustrate that financial supervisors are perfectly aware of how inappropriate it is to trade preferred shares among retail investors

- **Vision of Banco de España**

  Banco de España warned in November 2002 on:

  > "its concern for the growing weight of preferred shares in the basic own funds of some institutions, as well as the form how, in certain cases, they were sold to traditional retail clients."

* Financial Market Law Professor at Universidad Carlos III de Madrid and Founding Partner of Zunzunegui Securities Lawyers.

[1] According to the International Organisation of Securities Commission (IOSCO), there is evidence that: "Complex products were often sold to elderly and senior investors with little investing experience and market knowledge" (*Suitability Requirements with respect to the Distribution of Complex Financial Products* February, 2012, p.49).

[2] "The financial crisis has evidenced the importance of settling these problems. Retail investors lost money because of investments that were not transparent or couldn't be understood. Additionally, retail investment products, including, minor structured products or insurance agreements with purpose of investment, were sold and continue being sold frequently to minor investors as substitute of simple products, such as savings accounts, even though these investors do not necessarily understand differences. This occurs in a context of absolute loss of trust of investors: a recent survey among consumers of all EU showed that they trust less in financial services than in any other activity sector", Presentation of rationale of the Proposal of Regulations of the European Parliament and the Council on the documents of essential data related to investment products.

[3] In this work we use the word "sale" in a broad sense including both the process of distribution, sale and the advice on preferred shares. However, the inappropriate distribution also affects other similarly complex and risky instruments such as perpetual subordinate obligations, to which many conclusions of this report are applicable.

[4] *Memoria 2011 sobre Atención de reclamaciones y consultas de los inversores de la CNMV* (Report 2011 on Investors Claims and Queries Center of CNMV), p.68.

[5] It includes Nova Galicia Banco, CatalunyaBanc and Bankia.

[6] *Memorandum of Understanding on the conditions of Financial sector Policies, prepared in Brussels and Madrid* on July 23, 2012, and *Master Agreement of Financial Assistance*, made in Madrid and Luxemburg on July 24, 2012, on the principle of absorption of losses "as much as possible" by mixed instruments, of the ones that make preferred shares (BOE No.296, dated Monday, December 10, 2012, s.I, p.84557).

[7] This article considers the Report dated January 2013, required by the Spanish Ombudsman, to prepare its report "Estudio sobre Participaciones Preferentes", Madrid, March 2013.

This warning is justified:

> "considering that some preferred shares were not aimed at the institutional market but they were sold to retail clients (with lower capacity of valuation of the risk related to the instrument), that, their liquidity in the secondary market is very low,[8] and because they offer a profitability which is not very consistent with the risk taken, the institutions could have a reputational risk. Specifically, if the profitability offered is affected by the risk premium resulting from the low right of first refusal of the preferred shares, the premium to be earned due to liquidity and the price of the option to purchase granted to the issuer (aspects not known by the small investor), it is not certain that, in some of these issuances, the residual profitability exceeds a fixed term transaction."

It is noted that the characteristics of the preferred shares are:

> "they do not grant the right to vote; their right of first refusal is only better than common shares; their form of compensation is fixed income securities, even though it is conditioned to the group earning benefits; and even though the term is not restricted, usually the issuer reserves the right to repay them with authorization for the supervisor (in our case, Banco de España)."

This note of Banco de España describes the complexity of the product, highlights its low profitability, and the higher risks, and warns on the problem of inappropriate sale of preferred shares to retail clients.

- **Analysis of CNMV**

  A study of CNMV dated 2007 recognises that:

  > "Preferred shares due to their financial characteristics (in perpetuity, repayable in advance at the discretion of the issuer and ranking after subordinate debt in the preference of credits) are not financial instruments easily valued, specially for small investor."[9]

  According to the same study:

  > "preferred shares issued in Spain had in general issuance characteristics not very attractive for investors: the protection period has not been long, in most of the cases it has been 5 years, variable rate had small differentials in relation to the referential rate and the reimbursement had been set in all cases at par value without any premium compensating the risk of prepayment involved in these assets. The worse of all this is that their characteristics of perpetuity trapped investors in a doubtful profitability investment."[10]

  It is deducted then that CNMV was perfectly aware that preferred shares were an instrument not very attractive for retail investors from the profitability viewpoint, and also that it was difficult to value it.

Characteristics of preferred shares

From the previous quotes, we can outline the following characteristics of preferred shares that allow us to see them better and that will be useful to analyse the problem caused by their incorrect distribution.

- **They are not fixed income instruments**

  Preferred shares are, according to the European Securities and Markets Authority (ESMA), variable income products.[11] They are different from stocks because of their complexity, incorporating options. In 2004, CNMV found that "this instrument was sold as it were a fixed income product, when it is not so".[12] But it continued being sold as if it were fixed income and registered in bank statements as fixed income (preferred units/participaciones preferentes). It would have been better to call them "preferred stocks/shares" to warn the clients on the risk taken.[13]

[8] It is to note that CNMV received at that time claims for the lower liquidity of preferred shares listed in the AIAF market.
[9] Eduardo Blanco Marcilla, *Participaciones preferentes: Rentabilidad de las emisiones* Monografía No.24, CNMV, Madrid, 2007, p.5.
[10] Eduardo Blanco Marcilla, *Participaciones preferentes: Rentabilidad de las emisiones*. Monografía No.24, CNMV, Madrid, 2007, p.49.
[11] See CESR Q&A *MiFID complex and non complex financial instruments for the purposes of the Directive's appropriateness requirements* (Ref:CESR/09-559).
[12] *Informe Anual de la CNMV, sobre los mercados de valores y su actuación* (Annual Report of CNMV on securities markets and their performance, 2004), p.143.
[13] According to Manuel Conthe, President of CNMV since October 2004 to May 2007: "The expressions preferred stocks and 'acciones preferentes' are not misleading because the word 'stocks' warns he investor of the typical risk of this type of securities". And adds: "Unfortunately, the expression 'preferred unit/participación preferente' is misleading because it does not include the clarifying noun 'stock', results in a wrong impression or 'implication' that it is a 'privileged' financial value. This is the reason why, for a small debtor, a clearer expression would be ultra subordinated debt", used by CNMV or, even better, "perpetual ultra-subordinated debt", in "Preferred shares",

It is appropriate to indicate that preferred shares have a higher risk for retail investors that listed shares. Preferred shares are complex instruments and have liquidity problems. They are simple instruments easy to follow with the liquidity provided by the stock exchanges where they are listed.[14]

- **They are not highly profitable instruments**

  As we already said, according to Banco de España, preferred shares "offer a profitability which is not consistent with the risk taken", and it is doubtful that "residual profitability exceeds a fixed term". However, they have been sold so far as if they were highly profitable products. In fact, the main argument not to indemnify the affected is that "if you pay peanuts, you get monkeys", when the truth is that the promise of profitability had no argument at all, because as Banco de España says, its profitability does not exceed sight deposits. We are in a case of misleading information to consumers.

- **They don't have liquidity**

  Preferred shares are "ultra subordinated securities, that have a very restricted liquidity and therefore, if they traded, significant losses may be incurred in".[15] Most of the preferred shares are listed in AIAF, an official secondary market. What happens is that the AIAF segment has no liquidity, and they perform very few transactions.[16] And the opacity of this market allowed hiding this problem. With the creation of the SEND platform in 2011, the same AIAF market has transparency and investors may access to listing and know the lack of liquidity. This information related to the lack of liquidity of a product triggers a general alarm in investors.[17]

- **They are not preferred**

  It is not a preferred product, for instance, because it is allocated to the best clients. In fact, it is a product that has a high subordination. In case of insolvency of the issuer, all creditors collect first, and preference is only stated in relation to stockholders. But, what is important here is that the word "preferred" applied to the issuance of preferred shares of savings banks is misleading, because it indicates a preference in front of stockholders that do not exist. In savings banks, holders of preferred shares are not the ones before the last in collection in case of the insolvency of the issuer, but the last ones.[18]

Origin and delimitation of the problem

Once the product is examined, we realise that this is an opportunistic conduct of credit institutions that, in their own interest of strengthening their own funds, distributed among the clients of their branches, under the misleading name of "preferred units/participaciones preferentes", this financial product without reporting that they were not fixed income products, that their profitability was not attractive and that they have liquidity problems.

As we estimated, according to the same supervisors, preferred shares are an inappropriate product for retail investors. Then, because they are inappropriate, credit institutions should have refrained from offering them to retail clients.

CNMV recognises that, in the Spanish market, institutions usually provide an advice service in investments together with trading activity which results in receiving and executing orders.[19] The bank sells and deals with financial instruments but it may do it as

available at *http://www.expansion.com/blogs/conthe/2009/02/11/preferred-shares.html* [Accessed December 18, 2013]. It is a posteriori, when the institutions started calling "preferred shares/stocks" so that the Strategic Plan 2012–2015 of Grupo Banco Financiero y de Ahorros (Bankia), November 2012, available at *http://www.rtve.es/contenidos/documentos/plan_estrategico_bankia.pdf* [Accessed December 18, 2013].

[14] If recognised by art.79.bis.8 LMV which qualifies shares as simple instrument, and include preferred shares as complex instruments.

[15] Julio Segura, President of CNMV, in his participation at Parliament, DOCD, No.283, May 26, 2009, p.22.

[16] According to CNMV, in the Report 2011 on Claims and Queries of Investors (*Memoria 2011 sobre Atención de reclamaciones y consultas de los inversores*), "preferred shares are accepted to be listed in AIAF, Fixed Income Market. But considering the low liquidity, it is regular to designate liquidity supplier, actingunder given circumstances." The truth is that the secondary preferred market was a fiction. The institutions replaced the products that a client wanted to sell to other client at face value. It so described by CNMV in its Report: "The market characteristics of AIAF, where they are listed, caused that the execution of the orders is not automatic, but it requires the existence of an appropriate counterparty in the market. In other words, the fact that an issuance is accepted to be listed does not mean that there is a negotiation." And adds: "Taking into consideration these rules of operation, when a holder of preferred shares intends to sell, it was frequent that the intermediate institution sends the operation of sales to other client interested in the same institution at face value, provided that the face value and the market value were the same. However, due to the general market situation, among other reasons, some preferred shares start having a market value clearly below the face value. In this new context, the matching of transactions at a value different from market value among retail clients of the issuer and/or trader of securities, or among the clients and the same institution that provides the investment service, could not be accepted, unless it is evidenced that the transaction is made at a price close to reasonable or market value, if there was no liquidity contract or if it had terminated. In other words, the matching transactions among clients should not affect any of the affected clients and, in particular, any retail investor should acquire securities above the market or reasonable value. In a low market context, it would not be possible to sell them fast without taking losses in the invested capital."

[17] Considering this, an association of consumers qualified this situation as "Spanish *corralito*" (*http://laeconomiadelosconsumidores.adicae.net/?articulo=691* [Accessed December 18, 2013]).

[18] Preference will be exclusively made in relation to the holders of share installments, if they were issued. It has to be noted that the only savings bank that issued share installments was Caja de Ahorros del Mediterráneo ("CAM"), absorbed by Banco Sabadell, which fostered exchanges irrespective of the prohibition in the Memorandum.

[19] According to the Communication of CNMV dated May 7, 2009: "the experience from CNMV from the application of MiFID indicates at the advice activity declared and recognized by the institutions may be lower than the existing one. In fact, personal recommendations for the acquisition of a given financial product without adjusting to the legal framework provided for the advice relationships may become a frequent practice in relation to the client through a broad network of offices of financial institutions."

advisors before its clients. Then, they gain the trust of clients to sell them better any and all type of financial products.

In Spain, the current problem is restricted to the issuances of preferred shares made by savings bank rescued with public assistance. In all these cases, we are in a placement of own securities to the public, issued by the seller, with the resulting conflict of interest. With these issuances, savings banks reinforced their own funds in a crisis when capital needs were urgent. Undoubtedly, this fact was an important pressure component in selling these issuances, highlighting the advantages and hiding the risks.

In a time of increasing fear to risk, after the bankruptcy of Lehman Brothers, Spanish credit institutions, in particular, savings bank in 2009 placed preferred shares (participaciones preferentes) and other hybrid instruments for 21.6 Billion Euros, mostly among retail investors.[20]

Possibly we are in an omission of the authority of preventive control by financial supervisors and a failure of the monitoring system. Banco de España knew that the collection of such a volume of its own funds through the placement of preferred shares in branches of credit institutions affects the reputation of these institutions in front of their best clients, those which have certain volumes of funds, because it so stated in its own publications on financial stability. In its turn, CNMV through claims of clients or its own inspections knew about the bank negligence in the performance of conduct rules. After the bankruptcy of Lehman Brothers, CNMV made an ad hoc supervision on the trading of products issued by this bank, including preferred shares and it could verify the deficiencies in the performance of conduct rules.

From the point of view of savers, the search for profitability for savings is a rational behaviour. Following the recommendations of a financial advisor is a diligent behaviour. It is the bank which offers the product and recommends it to the client in an advice relationship. As we trust a doctor, it is logical that we trust our bank or savings bank. One takes care for our health; the other takes care of our money. But the reason is that nothing can be challenged to a saver for the simple fact of looking for a profitable placement of his savings, the truth is that what institutions offer, as preferred shares (participaciones preferentes) was not a profitable product, according to Banco de España. Then, in this case, a client cannot be held liable due to lack of diligence considering that "if you pay peanuts, you get monkeys", because they were just peanuts.

It is not a problem either caused by the economic crisis because most of the "participaciones preferentes" that continue without being exchanged were placed after the crisis in subprime mortgages of the summer of 2007. Through this banking instrument, knowing the situation of the crisis, it increased its solvency selling to a client a high risk product. In fact, the problem arises from an indiscriminate placement of a high risk complex product to retail clients at a time of crisis and the need to collect funds by the institutions.

The distribution of "preferred shares"

In Spain, financial instruments are sold through credit institutions that intermediate between the issuers of securities and savers. Intermediation is mandatory. Clients may not access to the market to purchase the product from the manufacturer. In case of preferred shares, the subject matter of this article, it results that the dealer is also the issuer of the product. So, the intermediary offering the product to the client is at the same time the issuer that seeks to raise funds, which causes a conflict between the client that intends to purchase a product appropriate to its goals and the selling bank interested in raising funds to improve its solvency ratios.

Preferred shares are being sold to Spanish savers in the branches of the credit institutions since 1998. First, they were issued by affiliates of credit institutions outside Spain and after the reform of its legal system of 2003, they were issued in Spain by the same institutions.[21] According to the Report of the Follow-up Commission of Hybrid Subordinated Debt-Capital Instruments dated May 21, 2013, between 1998 and 2012 there were issued €115.3 Billion of Hybrid Subordinated Debt-Capital Instruments, mainly preferred shares, subscribed by 3.1 Million of retail clients (families).[22]

The bad practices of institutions in selling preferred shares were recognised by CNMV. The queries received from clients' evidence "a lack of knowledge of the nature, characteristics and risks of the product and frequently a lack of adaptation of this to the investor."[23] According to CNMV, the clients that file a claim with this organisation indicate:

> "that they decided to purchase these products because they have been offered by the institution as products without risk, similar to long term deposits or a quarterly or biannual coupon bond,"

but in many cases the institutions were not able to evidence "having provided to the client written information on all the characteristics and risks of preferred

[20] This massive distribution of preferred shares occurred during the financial crisis, after Lehman Brothers' bankruptcy, when Spanish investors became more conservative, as appears from the studies developed by INVERCO (as, in Spanish, "Collective Investment Institutions and Pension Funds Association"). In its latest Savings Barometer (November 2013), INVERCO states that 6 in 10 Spanish savers defined themselves as conservative. In fact, by the results of the 2011 INVERCO' Savings Barometer, in 2009 only the 17% of the savers had a dynamic profile, which is the only considered adequate for offering the subscription of Preferred Shares. It is worthy say that INVERCO brings together nearly all the Spanish Collective Investment Institutions. In that way, those studies previously referred are issued among the clients of these institutions. The results would be different if the said studies were made in relation to the clients of local savings banks, were nearly all the savers had a conservative profile.

[21] Additional Provision 3a 19/2003 Act, dated July 4, of the juridical system of capital and economic transactions movements with foreign countries.

[22] This Follow-up Commission was established by Real Decreto-ley 6/2013, de 22 de marzo, de protección de los titulares de determinados productos de ahorro e inversión y otras medidas de carácter financiero.

[23] *Memoria 2011 de la CNMV, sobre Atención de reclamaciones y consultas de los inversores* (Report 2011 of CNMV, on Claims and Queries of Investors), p.28.

shares, prior to their contract." Additionally many claims "evidenced adaptation of the product for the investors who purchased it", without the institution which filed the claim having evidenced "that it had received enough information to evaluate the appropriateness or, as the case may be, the appropriateness of the product".

For years, these bad financial practices were evidenced in the hundreds of claims received by supervisors.[24] In their turn, several parliamentary initiatives highlight that we are before a social problem caused by the incorrect selling of a financial product that requires a political solution.[25]

Performance of supervisors

In this evident problem, CNMV only communicated to the associations of financial institutions and market some of the good practices that must accompany the placement of preferred shares to retail investors.[26] These communications were inefficient from the retail investor protection point of view. They are written with a technical language and its dissemination is restricted. In October 2006, CNMV published a Guide on the fixed income products, which for confusion of investors, included preferred shares among the fixed income products, concluding that: "Undoubtedly it is not a traditional fixed income product".[27]

CNMV itself has valued its performance, focusing on the supervision of the distribution of most of the preferred issuances of the last years concluding that: "regarding the dissemination to clients, the distribution performed complied with the rules in force".[28] But the facts show that CNMV did not do everything it could. It recalled to banking associations the good practice and open files to several financial institutions due to bad distribution of preferred shares, but together with these performances it could have forbidden the placement of preferred shares among retail investors as it prohibited the short-selling of banks stocks.[29]

Memorandum of the European Commission

The European Commission, through memorandum July 20, 2012, clarifies, in the defense of the taxpayers, that the stockholders and holders of preferred shares must be the first ones in bearing the losses caused by the insolvency of some banks. With this condition, the measures that may be adopted in order to repair the holders of preferred shares, unless from the ones that could be financed with European assistance.

Other interesting sections of the Memorandum are:

> "Banks and their shareholders will take losses before State aid measures are granted and ensure loss absorption of equity and hybrid capital instruments to the full extent possible."[30]

And it adds a section about the "Burden sharing", according to which:

> **"Steps will be taken to minimise the cost to taxpayers of bank restructuring.**
>
> After allocating losses to equity holders, the Spanish authorities will require burden sharing measures from hybrid capital holders and subordinated debt holders in banks receiving public capital, including by implementing both voluntary and, where necessary, mandatory Subordinated Liability Exercises ('SLEs'). Banks not in need of State aid will be outside the scope of any mandatory burden sharing exercise. The Banco de España, in liaison with the European Commission and the EBA, will monitor any operations converting hybrid and subordinated instruments into senior debt or equity."[31]

The Government must report on a monthly basis to the European Commission of the subordinated obligations and the outstanding preferred shares, specifying the amounts placed among retail clients and the terms of repayment.[32] However, this data was not public. You have to go to CNMV to quantity the problem:

[24] From January 2007 to December 2011, the Department of Claims of CNMV received 485 claims for the sale of preferred shares, and this number has increased year after year, from the 19 received in 2007, to the 209 received in 2011 (*Informe sobre participaciones preferentes* (Preferred Shares' Report), CNMV, 23 de marzo de 2012, p.10).
[25] See the proposals—other than proposals of bil—submitted by the Parliamentary Group Izquierda Plural on preferred shares (BOCD, series D, No.31, February 7, 2012, pp.11–14), to create a sub-committee to study the sale of complex products and the risk to retailers (January 27, 2012), and for CNMV to review the process of selling preferred shares (January 31, 2012); the Proposal of Bill of the socialist Parliament Group to exclude the distribution of the financial load of the rescue of the holders of preferred shares, requiring CNMV the individual examination of their sale, dated November 30, 2012.
[26] In 2005 he sent a letter to the financial institution associations recommending allocating 10% of the issuance to the institutional section. Likewise, it protected itself from the price paid by retailers because it has a reference, In this same line, it will communicate to the market on February 17, 2009, that the issuances allocated to retailer will be accompanied of a valuation of an independent expert. In its turn, on May 7, 2009, it reports the information conditions how the preferred shares must be sold, in particular, the ones issued by the dealer itself. May 17, 2010 recalls the necessary management of the conflicts of interests in order cases.
[27] *Guía de la CNMV sobre los productos de renta fija* (CNMV's Guide on fixed income products), 2006, available at *http://www.cnmv.es/DocPortal/Publicaciones/Guias/guia_rentafija.pdf* [Accessed December 18, 2013]. In the answers to the complaints of investors arguing a bad praxis because it sold preferred shares as it were a "fixed income" product, the bank usually refers to this guide as an argument to hold harmless from liability for following the criterion of the supervisor.
[28] *Informe sobre participaciones preferentes* (Preferred Shares' Report), CNMV, 23 de marzo de 2012.
[29] Under the art.85.2(j) of Law 24/1988, dated June 28, of the Securities Market, according to which CNMV may "agree on the suspension or limitation of the type or volume of operations or activities of individuals or legal entities in the securities market."
[30] *Memorandum of Understanding on the conditions of financial sector Policy in Brussels and Madrid* on July 23, 2012, and the *Master Agreement on Financial Assistance*, made in Madrid and Luxemburg on July 24 2012, BOE No.296 Monday, December 10, 2012, p.84557.
[31] *Memorandum of Understanding on the conditions of financial sector Policy in Brussels and Madrid* on July 23, 2012, p.84557.
[32] *Memorandum of Understanding on the conditions of financial sector Policy in Brussels and Madrid* on July 23, 2012, p.84563.

> "Out of the 22.374 million Euros of preferred shares issued by financial institutions held by retail investors, approximately, there would still be without offer of exchange a balance of roughly 8.500 millions."[33]

This data has to be actualised considering the latest information provided by the Follow-up Commission of Hybrid Subordinated Debt-Capital Instruments.

The legal framework

This chapter discusses the legal scheme applicable to the distribution of preferred shares, including references to the Community law, as a necessary basis to layout an improvement of the saver protection system. Let's present the most relevant risks in the legal framework with the single purpose of identifying its weaknesses and pitfalls.[34]

The legal framework is based on transparency and the adaptation of the product to the client's profile. In case of application of the legal framework, an indiscriminate distribution of preferred shares would have been prevented in the branches of credit institutions because it is a product inappropriate for retail investors, according to the criteria of Banco de España and CNMV.

Contrary to what it is usually stated, the obligation to adapt the profile of the client does not result from the Directive of the European Union of financial instrument markets in 2007, known for its English abbreviation "MiFID".[35] The obligation of institutions to adapt their product to the client profile comes from the General Code of Conduct of the Securities Market of 1993. The MiFID develops this obligation, already existing in the Spanish Law, requiring the institutions to pass to the client certain questionnaires (known as MIFID's test).

Act number 47/2007, of adaptation of the Securities Market Act to the MiFID, specified the obligations to outline the client characteristics already contained in Royal Decree 726/1993, classifying preferred shares as a complex instrument. Even though complexity does not mean necessarily a higher risk, the truth is that the complexity of a financial product affects the understanding by the client of financial risks. A product is complex when it is hard to understand by a retail investor.

On the other side, it is appropriate to indicate that as shown in many prospectus of the foreign preferred shares, for instance preferred shares of Bank of Ireland, in countries like Italy or France, they were only targeted to qualified investors (*operatori qualificati* or *investisseurs qualifiés*). However, CNMV allowed an indiscriminate placement of preferred shares in the credit institutions branches. In the aggregate, in Spain we have a good legal framework but there was not effective compliance.[36] It can be improved, but having met the problem would have been avoided.

The reform approved by 9/2012 Act,[37] has a restricted approach. It requires the intermediary to highlight the differences with bank deposits and include before the signing in the purchase order a non-convenience statement, when this is the result of the test.[38]

The European Commission has prepared a proposal of regulations on information to the investor about distribution of investment products including measures on the advice and the process of sale, in many cases decisive for the election of investor.[39] According to this proposal, the investment products must be accompanied by a document of manufacturers' data when they are sold to retail investors. It must be a short document, without technical language.

In its turn, the European Commission proposes two forms of performance in the examination of the MIFID. It regulates the sale and the advice of the reform of the Directive (MIFID II), on the one side. And, it regulates the products and the information on the product through a Regulation (MIFIR), with a new component: for the very first time supervisors have the capacity to prohibit or restrict the distribution of financial products.

From the same perspective, the International Organisation of Securities Commission (IOSCO) keeps nine principles to strengthen the protection of an investor in the distribution of very complex products.[40]

[33] *Boletín de la CNMV* (Bulletin CNMV), trimestre I, 2012, p.30.

[34] On financial regulation, there is abundant bibliography. For all: *Derecho bancario y bursátil*, conducted by Fernando Zunzunegui, 2nd edn (Madrid, 2012); and Fernando Zunzunegui, *Derecho del Mercado Financiero*, 3rd edn (Madrid, 2005).

[35] Directive 2004/39 on markets in financial instruments amending Council Directives 85/611 and 93/6 and Directive 2000/12 of the European Parliament and of the Council and repealing Council Directive 93/22 [2004] OJ L145/1.

[36] We had good "law on the books", but poor "law in action", in the terminology of Andrea Perrone and Stefano Valente, "Against All Odds: Investor Protection in Italy and the Role of Courts" [March 2012] *European Business Organization Law Review* Vol.13 Issue 1, 32.

[37] Sections 3, 6 and 7 of the art.79 bis of the Securities Market Act, on the final provision 3.5 and 6 of Law 9/2012, dated November 14. This provision also modifies the LMV to increase the threshold when a private offer is considered private, when an offer of securities is considered private, and therefore, is exempted from registering and publishing a leaflet.

[38] Considering the recommendation made by the Ombudsman. See Press Release of the Ombudsman dated June 20, 2012, according to which: "With this proposal, the Ombudsman intends that any investor, irrespective of his training, has, at the time of signing this data sheet of the product and the contract provided for by CNMV, in the area above the signature box of the client, a notice on the risk or hazard of the product."

[39] See 2012/0169 (COD) Investment products: key information documents. This proposal of Regulations is applied to all products that may be offered as an alternative to sight deposits, including preferred shares, subordinated obligations and structured deposits. It is not applicable to deposits, insurances and pension funds. The proposal includes a document with the essential data to prepare by the manufacturer of the product in a standard form similar to the one existing for the investment funds. It must be short, without legalese or technicalities. The liability falls to the manufacturer, and it is the manufacturer that has, in case of claim of the investor, the burden of proof of having prepared a document of essential data and available to investors. This is essential for the investor to know how much it purchases. The leaflet of the issuance and the brochure complies with a supplementary duty of market transparency.

[40] IOSCO: *Suitability Requirements with respect to the Distribution of Complex Financial Products*,February, 2012. That contains the following principles: *(1) Legal, Regulatory and Supervisory Framework; (2) Role of Oversight Bodies; (3) Equitable and Fair Treatment of Consumers; (4) Disclosure and Transparency; (5) Financial Education and Awareness; (6) Responsible Business Conduct of Financial Services Providers and Authorised Agents; (7) Protection of Consumer Assets against Fraud and Misuse; (8) Protection of Consumer Data and Privacy; (9) Complaints Handling and Redress; (10) Competition*.

Preventive measures

This section discusses the preventive measures for the improvement of the protection of saver in the distribution of preferred shares in order to prevent new episodes of opportunism by financial institutions. Before, we examine the experiences in other countries and the restrictions set by the Memorandum of the European Commission, as premises to take into consideration or the measures to be proponed. The measures have to be fair and balanced but also efficient. In other words, they have to be put into practice and with the expected results.

Analysis of the proposal of other countries

Before making proposals it would be appropriate to examine how other countries consider the specific case of inappropriate distribution of complex products among retail clients.

Towards the protection of financial consumer in the United Kingdom

In the United Kingdom, the Financial Service Authority (FSA) published its proposal of investor protection changing the approach towards a better intervention, with the possibility of forbidding the sale of certain products to certain section of the client.[41] From a control of the points of sale to prevent inappropriate sales, the system moved to an anticipated control that affects the design stage of the product so that new products meet the need of investors. This change of criteria is justified by several episodes of opportunism by institutions which caused major losses to investors.[42]

A new authority was created to protect consumers, called *Consumer Protection and Markets Authority* (CPMA) that applies a more intervention and preventive approach. Under this new philosophy, a reduction of the products offered to the clients is accepted in order to reduce the possibilities of abusive sales. It is not to reduce to zero the possibility of abuse, but to reduce the episodes that affect a large number of clients and, if possible, prevent them.

The most critical point is how to reach balance between consumer protection, on one side, and keeping the capacity of election of consumer and innovation in financial products, on the other side. According to FSA, most of the consumers cannot be sacrificed assuming the risk of an abusive sale of a complex product, due to the advantages that could be obtained by a few if they are freely traded.

In the United Kingdom, the reform of the financial legislation has also been subject of a Parliament report with many references to the financial consumer.[43] According to this report, the principle of responsibility of consumer must be completed with a legal clarification of responsibility of the intermediary who must act in the interest of the Client, offering prompt advice. This is important because the simple supply of information does not improve significantly the capacity of consumers for making informed decisions.

Belgium moratorium

Belgium has traditionally focused on consumer protection, like in the rest of the European Union, in the disclosure of financial information. However, according to the Belgium supervisory authority (FSMA), it is impossible to start from the principle that these consumers have knowledge and skills to understand financial information and are willing to ask for available information. Because of this, it is considered necessary to participate in the process of the creation of financial products, in order to ensure that the new products meet the client requirements before they are traded. This approach was used as justification to propose to the sector a moratorium in trading complex products. It is a moratorium voluntarily accepted by institutions applied from August 2011. FSMA monitors the performance of this moratorium and has confirmed that the launching of structured products and has decreased in the Belgium market.

Italian reply

Italy, together with Spain, is the market with more cases of inappropriate trading of financial products.[44] In order to settle the problem, the authority of the securities market (CONSOB) approved a communication dated March 2, 2009, on the correction and transparency of intermediaries in the distribution of illiquid financial products.[45] In this communication, it is recognised that the capacity of the intermediary is defined as a service in the interest of the client, losing the qualification of a simple sale.

[41] FSA, *Product Intervention*, DP11/1, January, 2011, which goal is: "the development of the regulatory philosophy of the new conduct regulator and responds to the government's call for 'a frank and open debate about achieving the appropriate balance between the regulation and supervision of firms, consumer responsibilities, consumer financial capability and the role of the state", p.10.

[42] For instance, almost 450,000 SCARPs (a sort of atypical financial agreement) were sold from April 1997 and February 2004, giving rise to, after the researches of FSA, indemnities to clients for a sum of 159 million pounds, FSA, *Product Intervention*, DP11/1, January, 2011, Annex 3 p.2.

[43] House of Lords House of Commons/Joint Committee on the draft Financial Services Bill, *Draft Financial Services Bill, Session 2010–12, Report, together with formal minutes and appendices, Ordered by the House of Lords and the House of Commons*, dated December 13, 2011.

[44] As detailed by Andrea Perrone and Stefano Valente, "Against All Odds: Investor Protection in Italy and the Role of Courts" [March 2012] *European Business Organization Law Review* Vol.13 Issue 1, 35–36: "At the beginning of the new century, a very large number of investors, mostly retail, were affected by several financial debacles. It all began with the Republic of Argentina's bond default in December 2001. This involved about 430,000 investors and the total amount of defaulted bonds may have reached about 12.8 billion euros. The default of Cirio, a renowned food company, followed in November 2002. Approximately 35,000 investors were affected, for a total amount of defaulted bonds of 1.125 billion euros. The scandal connected to the financial product 'My Way-For You' and the spectacular default of Parmalat were next, in March and December 2003 respectively. The former cost about 100,000 investors 1.35 billion euros; the latter affected 85,000 investors and involved defaulted bonds worth approximately 2 billion euros".

[45] Comunicazione No.9019104,dated March 2, 2009, Il dovere dell'intermediario di comportarsi con correttezza e Trasparenza in sede di distribuzione di prodotti finanzia riilliquidi.

Lessons of the Lehman Brothers case in Hong Kong

In Hong Kong, inappropriate trading of complex products issued by Lehman Brothers between savers was the subject of a Parliamentary investigation commission, which report may be very useful for us.[46] According to the conclusions of this report, to create a deposit or make an investment requires a different attitude from the client's prospect. However, the study showed that many clients were not aware of what they were investing because they made no difference between a custodian services and investments. In fact, they were sold structured products when what they originally wanted was to create or extend a deposit in the bank. According to the report, the Lehman Brothers case was used to show that the transparency model through rules of conduct failed because it did not offer sufficient protection to investors, for several reasons, including:

- The abundant financial information does not result useful for the investors to adopt decisions with cause;
- the large number of claims shows that financial institutions has not complied with the obligations to protect the client;
- the rules of conduct of intermediaries must be completed with dealing prohibitions of certain products to certain category of investors;
- financial education does not offer the expected results, and it has to be recognised that the key message "do not invest in what you don't understand" did not reach the public investor.

After these considerations, the report leaves open the possibility that certain products may be traded among certain categories of investors only.

Lessons from the prevention side of Canadians

The Canadian banking system has been more immune to financial crisis. This stability may have contributed to the examination of the system made in May 2006, very oriented to the client's protection. According to one of the studies included in this examination of the system, the financial authorities must recognise the restrictions of retail investors affected by an excess of trust and credibility in their relationship with financial institutions, which results in an inappropriate taking of risks and a lack of diversification of investments.[47] We shouldn't be surprised, considering the lack of criteria and knowledge that retail investors rely blindly in the advice of intermediaries. The problem is that they may trust too much and this blind trust is not always corresponded. The fact is that just a few investors challenged the qualification of banking employees and just a few understood the conflicts of interest resulting from the incentives distributed by the sale of products. Maybe, according to these authors, it would have to pass from "know your client" to "know your advisor". Because of these reasons, the regulators must pay special attention in the commercial practices of intermediaries.

Institutional architecture

The authorities of the financial market usually look at systemic problems, and the authorities for the protection of consumers often think that financial services are an area for experts of financial authorities. The result is that nobody cares about financial consumer, as seen from the result of several surveys.[48] In order to overcome the problem, the institutional investor protection framework is always changing. There are authorities specialised in the protection of financial consumer.[49]

In Spain, it was announced an agreement to reform financial supervision with two authorities (*Twin Peaks*).[50] According to this model, Banco de España would be the prudence authority in charge of monitoring the solvency of all financial institutions and CNMV would apply the rules of conduct of the institutions compared to the client. It is appropriate to indicate that during a few years, it was an institution that would have been used to protect the client from the opportunistic behaviour of banks. We are referring to Commissioners that never were designated in spite of the continuous requests made by the Spanish Ombudsman.[51]

In the current situation, with serious prejudice to the trust of savers in the financial institutions and supervisors, we believe that an organisation should be set up similar to the one existing in other countries, starting from the

[46] *Report of the Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products*, that states that: "The Subcommittee considers that individual investors' lack of bargaining power and access to information had placed them in a disadvantaged position when negotiating with individual RIs to settle their cases. The recourse to legal action might not be a practicable option due to the time and costs incurred. There is thus a strong need to put in place a simple, speedy and affordable mechanism for resolving disputes between the aggrieved investors and the financial institutions."
[47] Richard Deaves, Catherine Dine and William Horton, *How Are Investment Decisions Made?* (Canada, May 2006).
[48] Jacqueline Minor, "Consumer Protection in the EU: Searching for the Real Consumer" [June 2012] *European Business Organization Law Review* Vol.13 Issue 2 163–168.
[49] Consumer Financial Protection Bureau (US), Financial Conduct Authority (UK).
[50] Gonzalo Gil and Julio Segura, "La supervisión financiera: situación actual y temas para debate", *Estabilidad Financiera*, 12, Mayo 2007, pp.10–40.
[51] Commissioners were created by 2002 Financial Act, which regulation was approved by Royal Decree dated February 20, 2004. According to this rule, there are 3 commissioners: Commissioner for the defense of client of bank services, Commissioner for the defense of investor, and Commissioner for the defense of the insured, and of the participation in pension plans. To be designated as a commissioner, it is required to have a renowned prestige in the financial area with over 10 years of professional experience. The term of office lasts 5 years and it is not renewable. Once they are designated, they are assigned to each of the financial supervisors who must provide them with technical and administrative assistance for the performance of their duties. They have autonomy to set the criteria and guidelines applicable to the exercise of their duties, acting independently from the supervisor.

model of the commissioners to protect specifically financial consumers, with the capacity to settle their claims.[52]

Premises for a better regulation

The political scenario is favourable to the protection of financial consumer, in particular, after the bank rescues.[53] In this framework, the protection of financial consumer appears to be a necessary component, a goal shared even by the financial industry. As there are some early measures to assist banks in difficulty, from the consumers' side, it is proponed to have early warning systems of bank abuses.[54]

The management of financial crisis that started in the summer of 2007 went through two phases. The first one concerned about the solvency of institutions and the risk of all the system (systemic risk), which bases are set forth in the meeting of G-20 in Washington in November 2008. The second phase, where we are more focused on the protection of financial consumer, is to restore trust. After an examination of the rules of solvency of banks, the rules for the protection of clients are now reconsidered. The before-the-crisis rules are oriented to strengthen transparency to make investor responsible for his financial decisions avoiding setting limits on freedom of contract. There was a warning on the hazards of the intervention on the products to restrict financial innovation and the capacity of election of consumers. Over-regulation has to be avoided. However, as a result of the crisis, it is emerging a more interventionist regulation to protect consumers of financial products.

The industry and CNMV agree that transparency contributes with an appropriate solution. They consider that the model of the Key Investor Information Document (KIID), prepared by the European Commission for trading investment funds,[55] secures useful information for investor. There agree that the volume of information is not important, but clarity of the message. Transparency cannot be confused with a lot of information.

But transparency, even if improved through simplicity, is insufficient. The complexity of the products offered must be restricted to retail investors. A very complex product such as a preferred share could never be understood by a retail investor in all its effects, and for this reason, it will always be inappropriate to offer it to this type of client. The understanding of information plays a major role. On the other side, the weakness of the chain of financial distribution must be compensated at the stage of creation of the product, through a simpler design of products.

Several studies indicate that the banks act in many cases in opportunistic manner when trading financial products and these behaviours cause damage to investors and affect the good performance of the financial system. Then, it must be concluded that there is an economic impact as a consequence of the loss of trust of investors. Additionally, it has to be taken into consideration that after removing the services of the State of Welfare, the protection of long term savings oriented to retirement, is a matter of general interest.

List of preventive measures

Once the problem of inappropriate distribution of financial products among retail investors is analysed, as well as the applicable legal framework and the premises to improve regulation, including considerations that arise from the reports made in other countries, it is time to define what we can do, especially but not only in Spain, to improve the trading of complex or risky products among retail clients. Due to the financial globalisation, most of these measures could be implemented in other jurisdictions.

This is a list of the measures, including from a proposal to strengthen transparency to the prohibition of trading the more complex and risky products.

Prohibition of offering inappropriate products

Banking must refrain from offering to clients financial products not appropriate for their needs.[56] This rule already exists but it is not fulfilled. The control has to be reinforced, if necessary, tightening sanctions. The CNMV should propose to the sector a moratorium in the trading of high risk complex products in the branches of credit institutions, until a legal reform is approved that ensures the appropriate protection of financial consumers.

Strenghten transparency

Transparency and clarity are essential for the investor to make informed decisions and to compare among different products and elect the most appropriate for the profile and goals of investor. But transparency must involve not only information of risks but also information on

[52] The Commission of Follow Up provided for in the agreement of Partido Popular and Partido Socialista Obrero Español, on January 29, 2013, looks more ad hoc to solve the problem of preferred shares than a stable organisation for the protection of financial consumer.
[53] This situation responds to more controverted measures such as taxes on financial transactions, the so called Tobin Rate, because of the Nobel price initially proponed.
[54] Approach of AMF, *The AMF's New Strategy Proposals* (2010), based on the *Report of Delétré* dated 2009, and FSA. See Niamh Moloney, "The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors?" [June 2012] *European Business Organization Law Review* Vol.13 Issue 2 186 fn.89.
[55] Key Investor Information Document ("KIID"), available at *http://ec.europa.eu/internal_market/investment/investor_information/index_en.htm* [Accessed December 18, 2013].
[56] This already happens with the consumption credit that should be liable and the lending is conditioned to a prior positive evaluation of the client's solvency (art.18 Order EHA/2899/2011, dated October 28, of client transparency and protection of bank services). Pascual Martínez Espín, *Nuevo régimen de transparencia y protección del cliente de servicios bancarios (Análisis de la Orden EHA/2899/2011, de 28 de octubre, de transparencia y protección del cliente de servicios bancarios)*, available at *http://www.uclm.es/centro/cesco* [Accessed December 18, 2013].

expenses, costs and fees collected by the intermediary. Additionally, the expected performance must be reported, with different scenarios.[57]

Control in the design to achieve simpler products

Transparency continues being a major tool. Even though, transparency must be completed with the intervention in the design and the trading of products. It must be implemented a process for the validation and labeling of products (similar to medicines and food products).[58] In order to be approved, the new product must meet the need of investors. The increasingly complex structured products were criticised for transferring to the client risks and for not being useful to meet their needs. In order to prevent this problem, there should be a process of internal validation that examines the needs of clients, the product information, the target group, the distribution channels, the advertising support and the information to supply for a correct follow up of the product once it is sold.

Labelling of financial products

Protection of financial consumer would be strengthened with a correct labeling of the products that allows the client to select the appropriate ones according to its needs, and rule out the inappropriate ones. Additionally the labeling allows comparing among different suppliers which this comparison involves for free competition. In this respect, as the press release of the Spanish Ombudsman said dated June 20, 2012:

> "an effective system could be for instance a simple and intuitive color based system, as the ones used by traffic lights where green indicates a low risk, yellow medium risk and red a high risk."

It is a proposal defended by the doctrine,[59] and included in the manual of procedures of any financial institution.[60] In the European Union, this formula is already applied in Denmark and Portugal.[61] It is worth mentioning that considering the denial of the industry and a supervisor, it is preferable to have the simplicity of the traffic lights than other more sophisticated classifications only understandable by professionals.

Prohibition of high risk complex products

The issue discussed is if high risk products should be offered to retail clients considering the information transparency as an appropriate tool to mitigate the risk of affecting them. After recent experiences and studies made in other countries, we understand that the myth of free election of investor, and his autonomy as subject responsible for his decisions, has to be overcome. Certain products must not be distributed among consumers, to prevent damage. The trend is towards tolerance zero, towards behaviours that may result in harm to consumers uninformed. In this line, there are guidelines in the United Kingdom, where FSA radically changed its strategy in client protection. This change, towards the intervention of products is setting the pace in the European agenda. In Spain, there are several parliamentary initiatives towards that direction.[62]

Financial regulation aims at a higher awareness of retail investor and a vulnerable consumer of potentially toxic financial products.[63] Society, as a whole, benefits when investors make decisions based on information. With more prudent decisions, citizens are prepared better for their retirement and do not need to use the security network of the State of Welfare.

[57] The *Syntethic Risk and Reward Indicator* (SRRI) used by the industry is not sufficient.

[58] Proposal of the Belgium Parliament, in Doc. parl. Chambre 2008–2009, Doc 52 1643/002, p.549, that contains the following recommendation: "La commission propose de renforcer la traçabilité des instruments financiers, à l'instar de ce qui se fait mutatis mutandis pour les produitspharmaceutiques (Agence de médicaments) et les denréesalimentaires (Agencefédérale pour la sécurité de la chaînealimentaire). Ceci s'appliquerait aussi bien au niveau des produits détenus par les institutions qu'aux produits proposés à leur clientèle." In this line of ideas, the European Parliament considers it necessary that the design of investment products, including structured deposits, meets the needs and characteristic of the addresses adopting measures to guarantee that the product is treated in the target group, and the manufacturer to evaluate that the product matches the design and determine if the target market is still appropriate (Amendment approved by the European Parliament, October 26 2012, that adds a s.51 bis to the presentation of rationale of the proposal of Directive of the European Parliament and the council related to the market of financial instruments, which annuls Directive 2004/39 of the European Parliament and the Council (restated version) (COM(2011)0656-C7-0382/2011–2011/0298(COD)).

[59] "Considering the increasing complexity of financial instruments, it would be advisable to distinguish them by category. For instance three categories can be differentiated depending on a higher or lower complexity and risk. The red category of high risk financial instruments and a great complexity of distribution are prohibited to non-professional investors. The yellow category of medium risk instruments with a certain level of complexity that may be sold to non professional investors provided that it is recommended by an independent advisor, as a doctor prescription. Finally, the green category of simpler instruments and low risk that may be directly traded among non professional investors." (Fernando Zunzunegui, "Hacia un estatuto del inversor", *Revista de Derecho del Mercado Financiero*, Working Paper 1/2006, December 2006, p.14 fn.30; also published in *Anuario Euro-Peruano del Derecho del Comercio*, núm. 2/3, Perú, 2007, pp.21–52).

[60] *Manual de Procedimientos del Grupo Santander para la comercialización minorista de productos de inversión* (Manual of Procedures of Grupo Santander for retail trading of investment products), 5 de marzo, 2004.

[61] *Regulamento da CMVM No.2/2012, Deveres Informativos Relativos a ProdutosFinanceiros Complexos e Comercialização de Operações e Seguros Ligados a Fundos de Investimento* (Portugal); y *Executive Order No.345 of April 15, 2011, on Risk-Labelling of Investment Products Executive* (Dinamarca).

[62] See Proposal for a Bill on transactions to exchange preferred shares, of the Grupo Parlamentario Socialista, dated June 1, 2012, that proposes to add a final fifth provision of the Securities Market Act, stating that: "trading of preferred shares among retail clients is forbidden to all institutions". (BOCD, series B, No.75-1, dated June 8, 2012. To the same respect, the amendment of Izquierda Plural aimed at prohibiting the trading of perpetual debt and other risk assets among retail clients (BOCD, series A, No.23-2, dated October 26, 2012, p.5.

[63] It is appropriate to indicate the difference between prudent savers and robust risk-takers (Niamh Moloney, "The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors?" [June 2012] *European Business Organization Law Review* Vol.13 Issue 2). The difference between savers and takers is frequently used in reports required by the European Commission. Then, Optem Report for the EU makes a difference between household investors, prudent savers, who try to obtain safe investments, that should be treated as consumers or gamblers, who are prepare to take risks (*Pre-Contractual Information for Financial Services, Qualitative Study in The 27 Member States, Summary Report*, January 2008). Once, French TNS-Sofres Report makes a difference between small investors that do not intend to take risk and want safe products (TNS-Sofres, *Investigation of Investment Information and Management Processes and Analysis of Disclosure Documents for Retail Investors* (2006), Report for the AMF, at p.8).

Master agreement for savers

A model of master agreement of financial services must be approved including the prohibition of offering complex products to the retail clients.[64] Then, in order to offer or to contract complex products, it would be necessary to have a prior request by the client and the signing of other contract including the warning that by signing the contract, there is a possibility of losing savings. This system is preferable to the creation of a Robinson List of risk investments, so that any person that intends that his saving is not invested in risk products could be registered in this list. According to this proposal, before executing a purchase order of a high risk product, intermediaries should verify that the client is not included in the list.[65] But it would be better, according to the MiFID, to consider any branch client as a retail investor and as such provide that client with the maximum degree of protection. He should be offered a draft agreement, by default, where the intermediation service is restricted to green products, those where capital is not compromised. Under this framework agreement, the bank is forbidden to offer products at risk where clients may lose the invested capital. In order to offer client risk products, it would be necessary to execute another agreement indicating in the first page and in the last sheet of signatures a warning that if signing, he may lose the capital in financial investments.

Financial education

Financial education must continue but acknowledge that its effects may be in the medium and long term. It is only a supplementary tool on the protection of investor. We cannot rely on financial education to overcome the information asymmetry that separates intermediaries from financial consumers and that will make investors autonomous people responsible for their decisions.[66]

Control of incentives

The salary of bank employees must not be in conflict with the obligation to protect the interest of clients.[67] Advisors that work with clients as independent freelancers may only collect fees from the client; any transfer of fees by manufacturers or intermediaries is forbidden.

New authority for the protection of financial consumer

As it already exists in the United States and the United Kingdom, there should be an authority in charge of the protection of financial consumer, separate from the Government and financial supervisors. This authority should have the capacity to act on behalf of consumers, in order to obtain indemnities oriented to repair the prejudice caused by intermediaries' bad practice.[68]

Palliative measures

This section deals with some proposals to palliate the situation of people who was adversely affected by the inappropriate trading of preferred shares, because of the lack of information or because they did not fit the client profile.

We cannot generalise.[69] Any redress must be made on a case by case basis. Investors who made informed investment decisions must bear the consequences of said decisions. Only those clients who were not informed on the risks or those who due to their lack of knowledge or experience could not understand the product must be compensated. Experienced people who were informed have no right to be compensated. The informed investor takes the market risk.

There are several ways for the clients to claim damages. A claim may be filed with CNMV or, if the entity so accepts, they can resort to arbitrators of consumers, seeking for a settlement with the entity or an award deciding the controversy. Unless it was referred to arbitration, at any time a civil proceeding or suit may be filed with a judge. There is principle of preliminary criminal proceeding which means that upon filing a criminal proceeding any civil proceeding is cancelled.

[64] In the Law of Payment Services (art.18 onwards) and in the Securities Market Act (art.79 ter) there is a signature in the master agreement that must be set prior to the services of the financial consumer.

[65] Vid. Fernando Gomá, *Una propuesta sencilla contra los productos financieros tóxicos: un registro de autolimitación de riesgo* (A simple proposal against toxic financial products: a register of risk delimitation), 10 de octubre, 2012, at *http://hayderecho.com/* [Accessed December 18, 2013].

[66] In relation to this measure, CNMV and Banco de España have published a document, dated July 2013, in which they present the Financial Education Plan for 2013–2017. This project born in 2008 with a term of 4 years, and has been extended in order to achieve the objectives pursued. The document is available at *http://www.cnmv.es/DocPortal/Publicaciones/PlanEducacion/PlanEducacion13_17.pdf* [Accessed December 18, 2013]. Moreover, the Ibero-American Securities Markets Institute (*Instituto Iberoamericano de Mercados de Valores*) has recently published a document dealing with investor protection in Ibero-America, which dedicates an entire chapter to financial education, and it is available at *http://www.iimv.org/estudios_Proteccion.htm* [Accessed December 18, 2013].

[67] Amendment approved by the European Parliament, on October 26, 2012, adding s.52 bis to the rationale of the proposal of the Directive of the European Parliament and the Council related to financial instruments, annulling Directorate 2004/39 of the European Parliament according to which (restated version) (COM(2011)0656-C7-0382/2011–2011/0298(COD)),: "salary of employees in charge of selling or providing advise on investment should not, therefore, depend only of the goals of sale or the benefits of the company of a specific financial instrument, since it would create incentives to facilitate information that is not fair, clear and not misleading and to make recommendations that do not result in a higher interest of the client."

[68] This authority is similar to the one enjoyed by SEC (Fair Fund), that since its setting up in 2002 allowed for the distribution of 4.600 million Dollars among the person affected by fraud and other financial abuses (See IOSCO: *Suitability Requirements with respect to the Distribution of Complex Financial Products* (February, 2012), p.48 fn.131).

[69] As Manuel Castilla says: "Certainly, the legality of the process leading hundreds of thousands unsophisticated investors to acquire preferred shares issued by our credit institutions for capitalizing shall not be generalised. Each issuer, each type of preferred shares, each investor and even each business investing in them involves, in fact, different circumstances potentially relevant for judging the legality of their acquisition". (Vid. Manuel Castilla, "Riesgo, información y error en la distribución de participaciones preferentes emitidas por entidades de crédito" *Derecho de los negocios*, 23, No.265-266, 2012, p.15).

Pecuniary liability of the Administration (CNMV/BdE) may be claimed, and this autonomous action is not stayed if a criminal proceeding is brought.

The seriousness of the problem suggests a political action beyond the regular claiming procedures. However, alternative solutions put forward must take into account the costs and benefits and their impact on both the clients damaged due to malpractice and on the entities and the system as a whole.

Besides, it must be borne in mind that in the financial regulation there is a principle of equal treatment of the investor, so that the clients damaged by the inappropriate trading of other issues of preferred shares or other products of similar risk and complexity may invoke the measures offered to the holders of preferred shares of entities redeemed to their own benefit. In brief, there might be a call effect looking for redress which must be assessed when making the decision of somehow compensating the holders of the preferred shares (pull factor).

Arbitration under the control of the bank

Arbitration is a solution that must be accepted by the bank and the client. Nova Galicia Banco and Catalunya Banc are offering to resort to consumer's arbitration to some clients chosen by the entity through an external advisor, specifically PWC for Nova Galicia Banco, and Ernst & Young, for Catalunya Banc. Regarding Bankia, KPMG has been appointed for this screening duty. This may result in an action contrary to the principle of equal treatment of the investor leading the financial regulation. Any and all clients who purchased the same type of product with an entity are entitled to receive the same offer of arbitration.[70] On the other hand, it is not correct to elect the auditor of the bank, mainly if it is involved as consultant or auditor in the issue of the preferred shares.[71]

Follow-up commission

The two majority political parties have agreed to establish a follow-up commission regarding the arbitration proceedings.[72] Following this initiative, a commission of inquiry has been set up, under the Chairwoman of CNMV, as responsible for the trading of the preferred shares, and the Vice Presidency of a representative of Banco de España, who should oversee the reputation of the banks. The purpose of this commission is to establish objective criteria for screening arbitration requests. It is accountable to the Parliament and the Government on the proceeding, making proposals to improve the distribution of financial products. The Follow-Up Commission has established the criteria to screen the requests, but giving more importance to social issues than to issues of law. The latest Report of the Follow-Up Commission dated on September 2013 reflects the scale of the problem, with 472,946 retail clients asking for an arbitration redress and 6,487 judicial claims.

The creation of this commission, involving CNMV in the process, is a step forward the right solution but is not enough. The screen is in private hands, under the control of people who are related to the parties thereto,[73] and in the hands of auditors that have assessed the issues of the preferred shares subject matter of the controversy.

CNMV as natural manager of complaints

Financial regulations provide for the participation of CNMV as manager of the claims filed by the clients damaged by the inappropriate trading of financial products.[74] If the clients file a claim with the entity and they are not paid, they can resort to the Complaints Service of CNMV. This service has the technical jurisdiction and the media to face this type of claims. It is a pioneer instrumentality in the use of electronic means and it could easily create an electronic window to serve the parties that were affected by the preferred shares. Document management is quite simple because all the relevant information to verify the information of the client

[70] This principle is set forth in the first additional provision of Royal Decree 629/1993 of May 3 on rules of conduct on the securities markets and mandatory registrations, under "Equality of treatment for clients of Credit Institutions", and stated that: "The National Securities Market Commission (ComisiónNacional del Mercado de Valores) and the Bank of Spain (Banco de España), in the framework of their respective competences, shall ensure that the rules on client protection contained in this Royal Decree do not cause any unequal treatment of clients because of the type of credit institution they are operating with." Indeed, one of the principles highlighted by Banco de España in relation to the rules on the Security Market: *http://www.bde.es/clientebanca/derechos/regulacion/fichas/ficha16.htm* [Accessed December 18, 2013]. This principle also prevails in the Spanish Company Law expressing the necessary equal distribution of benefits (see STS 3-X-2002). It is a principle set out in art.43 of Royal Decree 1082/2012 of July 13 approving the Regulation for the implementation of Law 35/2003 of 4 November on collective investment institutions and by IOSCO in this same scope of collective investment (see *http://www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf* [Accessed December 18, 2013]). It is also present in Community law. It is mentioned in the Explanatory Memorandum of the Regulation 583/2010 establishing applicable provisions of Directive 2009/65 of the European Parliament and of the Council as regards the key information for the investor and the conditions to be met when providing this information or the brochure in a durable medium other than paper or through a website [2010] OJ L176/1 (DOUE-L-2010-81245). Federico M. Mucciarelli, "Equal treatment of shareholders and European Union law. Case note on the Decision "Audiolux" of the European Court of Justice" [2010] E.C.F.R. 1, 158–167. Likewise, the European Commission recognises that the rules on transparency are justified "in order to ensure the equal treatment of investors and a level playing field in financial sectors" (Draft of Commission Regulation implementing Directive 2009/65). The principle of equal treatment is also set forth in art.24 of Royal Decree 1066/2007 of July 27 on rules on takeover bids for securities, under which: "Takeover bids may be made as a purchase and sale, as a swap or exchange of securities or as both at the same time, and must ensure equality of treatment among the holders of securities that are in the same circumstances."

[71] According to information available in CNMV: PwC was the statutory auditor of the company issuing the preferred shares assumed by NovaGaliciaBanco; Ernst &Young was the evaluator of the preferred shares of Caja Canarias and de CaixaLaietana; and KPMG, in charge of filtering Bankia's arbitrations, acted as evaluator of the economic conditions of the issuance of preferred shares, more specifically the issuance of CaixaGaliacia preferred shares, Series D of March 5, 2009 and Series E of September 15, 2009, and Series X of June 2008 from Santander Finance Capital SA, Unipersonal.

[72] Note on proceedings of preferred shares arbitration in nationalised credit institutions of January 29, 2013. Real Decreto-ley 6/2013, de 22 de marzo, de protección a los titulares de determinados productos de ahorro e inversión y otras medidas de carácter financiero.

[73] In breach of art.1256 of the Civil Code, under which: "The validity and performance of contracts cannot be left to the discretion of one of the contracting parties."

[74] Royal Decree 303/2004 of February 20, approving the Regulations of the Commissioners for the Financial Services Client's Defense (amended by Fifth Transitory Provision of Law 2/2011 on Sustainable Economy derogating all except arts 7 to 15 of the Regulations thereof), set out in Order ECC/2502/2012 of November 16 on implementation of the procedures for filing claims with the Complaints Services of Banco de España, The National Securities Market Commission and the Directorate-General for Insurance and Pension Funds.

must be held by the bank; the only thing the client must do is to fill in the complaint form. It shall be borne in mind that it falls to the bank the burden of proof of the obligation to inform and that the bank must compulsory keep a record of orders and of contracts, plus the keeping of cash and security accounts. In brief, upon opening a file of complaint, it is the bank that can and must send to CNMV a copy of the relevant documents to make a decision on the applicability or not of malpractice in the trading of the product. The client may add handwritten notes, e-mails or other documents that may contribute to clarify the relation kept with the bank.

The sole inconvenience of this solution is the lack of binding nature of the reports issued by the Complaints Service of CNMV. In fact, since the beginning of the financial crisis, it is more and more frequent that entities ignore the client even if the client has been awarded a favourable report from CNMV. However, considering the special situation we are going through, it could be agreed with the banks that have been rescued with public aids, whose administrators are persons of trust of public Administrations that in the claims related to preferred shares they undertake to accept and enforce the resolutions adopted by the Complaints Service of CNMV. So that if CNMV rules in favour of a client, the bank shall proceed to compensate the client for damage caused, for instance, by repurchasing the securities for the amount paid when the preferred shares were first purchased minus interests received. This would be the redress they would receive if a court declares the nullity of the contract. On the other hand, this formula kind of shares the loss and creates an incentive for the client to be more diligent in the future.

The option for consumer's arbitration is not considered desirable. The consumer authorities of the Autonomous Communities lack technical knowledge of CNMV regarding contracting of financial products. Even if CNMV contributes to fix criteria there are no guaranties that homogenous and equitable solutions will be reached. CNMV does not have either coordination powers regarding the consumer authorities of the Autonomous Communities. Furthermore, the territorial conflict existing in Spain does not allow to progress in that direction.

From a client perspective, the advantage of resorting to CNMV is that it does not close the judicial proceeding. However, resorting to arbitration does close the judicial option.

For all the reasons above, we believe it is appropriate to centralise in CNMV the management of claims related to the inappropriate trading of preferred shares.

Conclusion

This report approaches the trading system of preferred shares, called in Spain "participaciones preferentes", from a perspective of client protection in order to identify possible imbalances and malpractice and put forward the improvement of the system as well as redress proposals for the most damaged savers.

Preferred shares are high risk complex financial products placed at the branches of credit entities as an alternative for term deposits. Banks and savings banks offered them as if they were profitable fixed income with a safe coupon when, actually, it is a variable income that is not that attractive because of liquidity issues, which profitability is conditioned to a good operation by the issuer. They are own resources for banking institutions and a perpetual debt for investors.

Market rules put at risk unlucky clients. If they were tempted by profitability, they cannot complain now, when their investments failed, of having lost their money. Those who have invested in shares have lost some of their savings due to the crisis. Caveat emptor! This should be like this when the market works with transparency, i.e. when the consumer makes a choice knowing the risks. But the "participaciones preferentes" were offered with misleading information as regards their profitability and liquidity, hiding the risks. Savers were never informed that these were hybrids with problems of liquidity and profitability subject to obtaining gains.

Banks contend that if clients did not know it, they should have asked before buying. However, according to the information received from institutions, clients believed they were purchasing fixed-income securities by secured bonds that could be redeemed at anytime. Furthermore, branches presented them as a preferred product adapted to their profile. This being the case, why do mistrust their long life bank that also has taken the initiative to offer them the product? Being provided with clear information on what they were buying, fixed-income security by attractive bonds, there was no need to make any question. CNMV has confessed that banks kept liquidity fictitiously by reallocating preferred shares to other clients of the same bank branch. These bad practices were possible thanks to AIAF's opacity, the fixed-income market in which preferred shares were traded. It was precisely AIAF's reform that has shown the situation of lack of liquidity of these shares. When prices and positions were disclosed, investors could realise that what they bought was not what they were offered.

Failure of the investor protection system is caused, as any accident, by several linked causes as the trading of complex and high risk financial products among retail clients, conflict of interest arising the allocation of own products to reinforce the issuer's solvency, along with the breach of the rules of conduct, in particular the one obliging not to offer inadequate products and the one prescribing warning of risks of the purchased product. All those circumstances have led to the current situation described, which can be characterised as the greatest case of mis-selling of financial products in financial history.