REDRESS IN RETAIL INVESTMENT MARKETS

International Perspectives and Best Practices

CFA Institute

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CFA Institute is the global association of investment professionals that sets the standards for professional excellence. We are a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community.

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Executive Summary

Adequate complaint-handling and redress mechanisms are central to increasing investor trust and participation in retail investment markets. In a survey conducted in 2013 by CFA Institute and Edelman,[1] investors identified "taking responsible actions to address an issue or a crisis" as among the most important elements on which investment service providers can build trust.

The recurrence of product origination and sale practices that are not in the best interests of investors highlights the importance of effective mechanisms for investors to seek redress. Mis-selling remains a top concern in the areas of market integrity and investor trust, despite some steps toward regulatory reform, highlighted by the CFA Institute Global Market Sentiment Survey 2014.[2]

"Investor redress" refers to the enforcement of the rights of retail investors and users of financial services by their demanding the cessation of an illegal activity or compensation for harm caused by misconduct. Conversely, it does not refer to compensation of losses resulting from market risk or other risks borne by the investor legitimately. No right is effective unless it can be easily enforced in practice.

In this paper, we explore investor redress based on a survey of best practices and regulatory frameworks in Europe, Asia, and the Americas. We also examine specific redress schemes set up in instances of widespread investor detriment. On the basis of this analysis, we put forward recommendations to increase the availability and quality of redress mechanisms in retail financial markets.

State of Play at International and European Level

The High-Level Principles on Financial Consumer Protection,[3] endorsed by the G–20 in 2011, establish that consumers should have access to

[1]The CFA Institute & Edelman Investor Trust Study examines trust by investors in investment managers and explores what dimensions influence that level of trust. See www.cfainstitute.org/learning/future/getinvolved/Pages/investor_trust_study.aspx.

[2]The CFA Institute Global Market Sentiment Survey 2014 (GMSS) reflects the views and expectations of CFA Institute members on financial markets, integrity, and performance for the coming year. See www.cfainstitute.org/about/research/surveys/pages/global_market_sentiment_survey.aspx.

[3]See the G–20 High-Level Principles on Financial Consumer Protection, OECD, 2011 (www.oecd.org/daf/fin/financial-markets/48892010.pdf).

complaint-handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely, and efficient. The World Bank also considers these elements essential for the adequate protection of retail clients.

In many jurisdictions, resolving disputes through the courts of justice involves sizeable costs and complex or time-consuming procedures. For claims of small to moderate value, litigation is frequently uneconomical. However, in retail investment markets, relatively small claims can have a significant impact on the financial security of individuals.

Some jurisdictions provide small claims procedures that are less complex and less expensive for claimants or allow the grouping of similar claims under collective actions. However, these procedures are limited by the very low amounts that can be claimed and the very limited ability to consider the individual circumstances of each case, respectively.

Alternative dispute resolution (ADR), which takes place outside of the courts of justice, can provide a much simpler, faster, and cheaper way to resolve consumer-to-business disputes, including financial services–related and investment-related disputes. ADR can include mediation and/or arbitration. Arbitration ends with a decision or award that is binding on at least one of the parties.

Key Findings

- **Quality and use of ADR**

  We survey a number of ADR schemes in Europe, Asia, and the Americas in an effort to identify and promote best practices. We focus on Europe, where Directive 2013/11/EU will require EU member states to ensure the availability, quality, and independence of ADR schemes.

  - We find that ADR schemes are not always available in retail financial markets or fail to respect key principles, such as independence, accountability, and affordability.

  - Even where ADR schemes are formally available, they will not be used in practice unless service providers commit to participate in ADR or the law provides compulsory participation.

  - ADR schemes that integrate mediation and arbitration (in one escalating procedure, performed by the scheme's own staff rather than external arbitrators) are simpler and more cost efficient and expedient.

- **Use of ADR in instances of mass detriment to investors**

  We review the use of ADR in two instances of widespread detriment to retail users of financial services, which arise from suspected mis-selling: the sale of hybrid instruments to households in Spain and the sale of interest rate hedging products to small businesses in the United Kingdom.

  - ▲ We find that special-purpose ADR schemes can provide an efficient response to cases of widespread mis-selling because they can make provisions for both

    - elements common to all the cases of detriment at hand and

    - specific circumstances of each client, which are essential to determine whether the rules applicable to the sale process were infringed on.

- **Complaint handling and supervisory practices**

  We explore emerging best practices in the management of complaints from retail clients by service providers and supervisory practices regarding the monitoring of complaint handling and the cooperation between regulatory authorities and ADR schemes.

  - ▲ We find that an efficient system to manage complaints can contribute positively to client trust, reduce instances of recourse to ADR and the courts of justice, and provide valuable information to management.

  - ▲ We also find that complaints data can help supervisors to identify emerging risks to market integrity and investor protection and to better perform their enforcement, regulatory, and educational functions.

Summary of Policy Recommendations in Europe

Based on our research and analysis, we recommend that European and national authorities pursue the following policies:

- *Ensure retail investors can effectively access ADR* by setting up industry-wide ADR schemes with the ability to issue binding decisions and where participation is compulsory for service providers.

- *Provide guidance on the application of Directive 2013/11/EU*—notably, as regards the applicability of the notion of "consumer" to retail investors and the notion of "trader" to distributors and originators of investment products and financial services.
- *Increase transparency to foster awareness and comparability* across schemes and jurisdictions, both on the characteristics of ADR schemes and on the outcomes of ADR for retail investors.
- *Strengthen the financial dispute resolution network (FIN-NET)* with the capacity to monitor ADR schemes across the EU and to aggregate and publish all relevant information.
- *Enable the use of ADR in instances of mass investor detriment*, endowing the relevant public authorities with the power to set up special-purpose ADR schemes in cases of mass detriment.
- *Develop a common supervisory approach in Europe,* as regards the monitoring of complaint handling, supervisory cooperation with ADR schemes, and the exchange of information at the European level.

Section 7 develops these recommendations in full and provides a list of best practices for stable ADR in retail investment markets. Additional best practices are found in Section 4, as regards special-purpose ADR schemes.

1. Why This Paper?

The Global Market Sentiment Survey 2014, conducted by CFA Institute among its members,[4] identified the mis-selling of financial products and services as a top concern for investor trust, despite the numerous reforms adopted across jurisdictions to address this problem. In this same survey, CFA Institute members acknowledged the importance of improved governance practices and the enforcement of existing laws and regulations in increasing investor trust.

Crucially, most investors believe that the top attributes of an investment manager relate to integrity rather than performance. In a study on investor trust conducted by CFA Institute and Edelman, among institutional and retail investors, the following two attributes were listed as the most important in building trust: having transparent and open business practices and taking responsible actions to address an issue or a crisis.[5]

Building on these insights, in this paper, we focus on what financial service providers can do to safeguard client trust when a problem occurs in practice.

CFA Institute has a commitment to the promotion of market integrity and the interests of investors and end users of financial services. Earlier in 2014, CFA Institute published a "Statement of Investor Rights", which includes 10 core rights that are relevant to any user of financial services, whether in investment management, banking, insurance, or pensions. On the basis that no right is effective if it cannot be secured in practice, we have explored the mechanisms for retail investors to seek redress when they experience unfair detriment arising from misconduct by a service provider. In this paper, we bring together the findings from our research based on a survey of best practices and regulatory frameworks in Europe, Asia, and the Americas.

In this paper, we explore, and seek to promote, best practices for the handling of complaints and the organisation of ADR schemes.

[4]CFA Institute members are professionals working in all fields of the financial services industry, academia, regulation, and supervision who hold the CFA charter and adhere to the CFA Institute Code of Ethics and Standards of Professional Conduct.
[5]In this same study, when asked what attributes they consider most important when making a decision to hire an investment manager, investors cited "trust to act in my best interest" twice as often as "ability to achieve high returns".

CFA Institute Statement of Investor Rights

The 10 rights of investors and users of financial services, developed by CFA Institute:

1. Honest, competent, and ethical conduct that complies with applicable law.
2. Independent and objective advice and assistance based on informed analysis, prudent judgment, and diligent effort.
3. My financial interests taking precedence over those of the professional and the organisation.
4. Fair treatment with respect to other clients.
5. Disclosure of any existing or potential conflicts of interest in providing products or services to me.
6. Understanding of my circumstances, so that any advice provided is suitable and based on my financial objectives and constraints.
7. Clear, accurate, complete, and timely communications that use plain language and are presented in a format that conveys the information effectively.
8. An explanation of all fees and costs charged to me and information showing these expenses to be fair and reasonable.
9. Confidentiality of my information.
10. Appropriate and complete records to support the work done on my behalf.

2. Introduction: What Is Investor Redress?

Investor redress refers to the enforcement of investor rights, either by means of *injunctive relief*—the cessation of an illegal activity or the removal of an unfair contractual condition—or *compensation*—the award of damages for harm caused due to misconduct, as defined by law and regulation. Conversely, investor redress does not refer to compensating investors for losses that are due to market risk—or any other risk borne by the investor, instead of the service provider, in accordance with legitimate market practices.

Redress may arise from either private or public enforcement but is conceptually different from the repression of unlawful behaviours, which typically consists of punitive fines imposed through administrative or criminal procedures. In most jurisdictions, fines rarely benefit the victims of wrongdoing, whereas redress compensates directly those who suffer detriment because of unlawful behaviours. However, redress does not merely satisfy an individual interest; it also incites market discipline, which benefits other market participants.

The enforceability of rights by investors is central to the effectiveness of any investor protection framework. Indeed, no right is effective unless it can be enforced with ease—not just in theory but in practice, by means of accessible, affordable, and expedient procedures. The existence of effective mechanisms for retail investors to seek redress, when warranted, also plays a crucial role in building trust and promoting participation in retail investment markets.

At least four elements configure an effective framework for investor redress: (1) a transparent channel for customers to raise complaints, managed internally by each service provider; (2) efficient mechanisms for out-of-court resolution of disputes; (3) access to judicial review and traditional civil litigation as tools of last recourse; and (4) effective coordination of the first three elements and the roles of regulators and supervisors.

- *Internal handling of complaints by service providers.*

  Retail clients will first try to resolve a concern informally with the front office of their service provider or by introducing a formal complaint. Alternatively, clients may bring an action before a court of justice. However, if the client wishes to pursue ADR, most schemes require consumers to have first complained to their service provider.

- *Alternative dispute resolution.*

  If a client receives a negative response or no response from the service provider, an ADR scheme might be available for the client to file a claim against the service provider. However, the client will not be able to channel a dispute through an ADR scheme unless the service provider participates in this scheme or legislation provides otherwise.

  ADR can encompass conciliation, mediation, or arbitration, separately or combined within one escalating procedure. Conciliation and mediation help the parties to reach an agreement and settle the dispute, whereas the outcome of arbitration is binding, at least on the service provider.

- *The courts of justice.*

  ADR is frequently less expensive and faster than litigation, but it does not apply the same rigorous standards and protections as the courts of justice. Some arbitration procedures foreclose access to the courts for the client, whereas other arbitration awards are not binding on the client. Any choice to forgo the right to access the courts of justice should be well informed.

- *Coordinating the other elements.*

  Internal complaint handling, ADR schemes, and court actions cannot be considered in isolation. For instance, a fast and efficient court system can reduce the need for ADR. Alternatively, an ADR scheme with compulsory jurisdiction over service providers can reduce the number of cases that end in the courts of justice. Similarly, quality standards on internal complaint handling can work to reduce the number of cases that reach ADR.

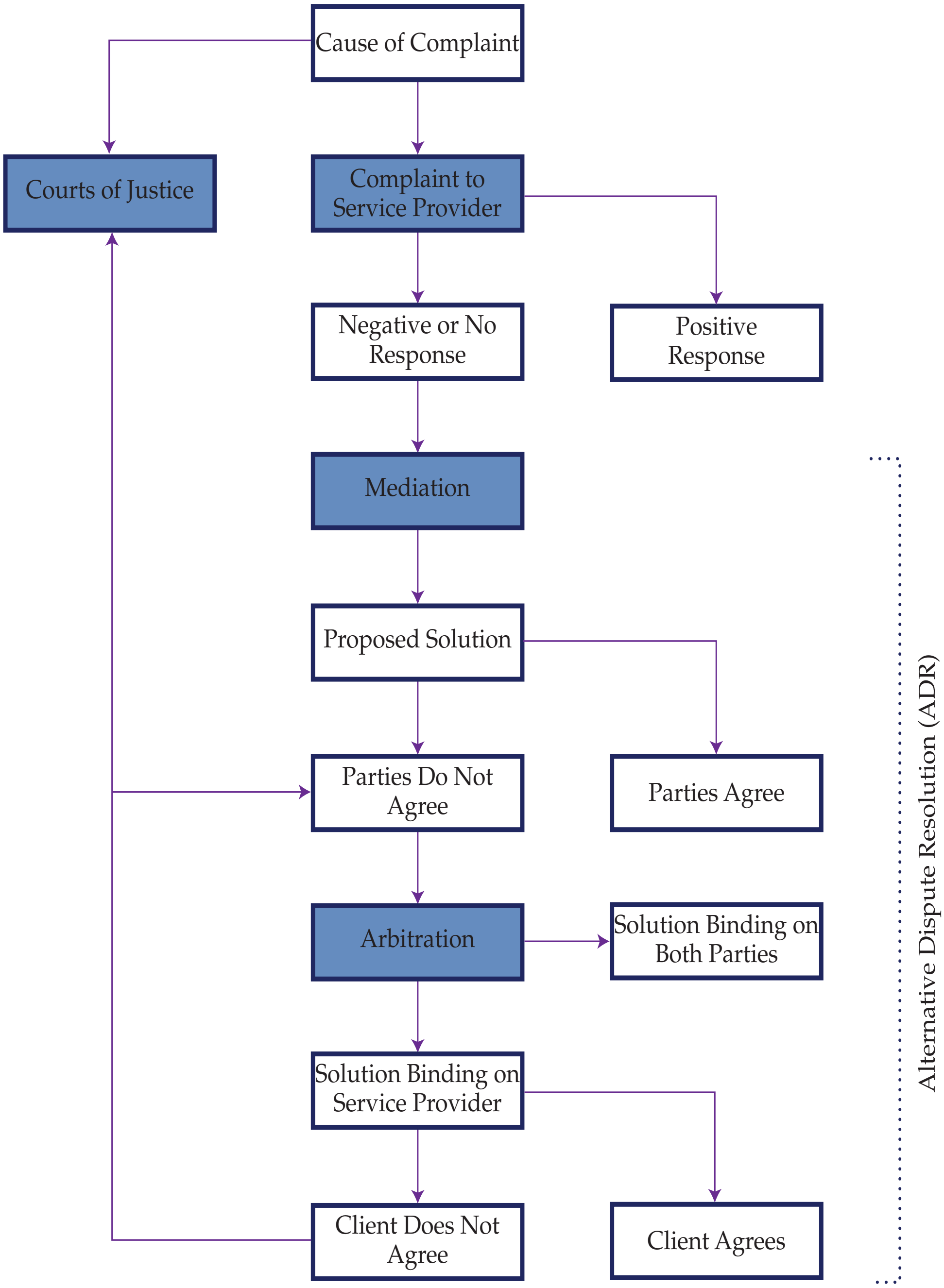
Figure 1 is an example of how some of these elements can best be articulated together. It comprises both mediation and arbitration. It is an illustrative example not intended to represent an actual process in any particular jurisdiction.

International Principles regarding Investor Redress

The High-Level Principles on Financial Consumer Protection state:

> Jurisdictions should ensure that consumers have access to adequate complaints handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient. Such mechanisms should not impose unreasonable cost, delays or burdens on consumers. In accordance with the

Figure 1. Illustrative Chain of Redress Procedures



> above, financial services providers and authorised agents should have in place mechanisms for complaint-handling and redress. Recourse to an independent redress process should be available to address complaints that are not efficiently resolved via the financial services providers' and authorised agents' internal dispute resolution mechanisms. At a minimum, aggregate information with respect to complaints and their resolutions should be made public.

These principles were developed by the Organisation for Economic Co-Operation and Development (OECD) Task Force on Financial Consumer Protection, in close coordination with the Financial Stability Board (FSB) and other standard-setting, consumer, and business organisations.[6] These principles were endorsed by the G–20 finance ministers and central bank governors in October 2011.

[6]Similarly, the World Bank provides guidance on good practices as regards (1) internal complaints procedures, (2) formal dispute settlement mechanisms, and (3) publication of information on consumer complaints. See World Bank, Good Practices for Financial Consumer Protection (June 2012).

3. Judicial Procedures

This section provides an overview of judicial procedures, both individual and collective actions, in the context of the European Union.

The court system often functions as a tool of last recourse—for instance, when a consumer dispute is not resolved directly with the service provider or with the help of an ADR scheme. Judicial procedures are usually more expensive and lengthy and less flexible than ADR procedures and other schemes for the out-of-court resolution of disputes. However, they offer the highest procedural guarantees and end in binding decisions that can be legally enforced.

The right to an effective remedy before an impartial and independent court is a key guarantee of justice, recognised as a fundamental right at the international, regional, and national levels.[7] The Court of Justice of the European Union has also played an important role in developing the principle of effective legal protection,[8] which includes the right to seek compensation in case of an infringement of EU law.[9]

Against this background, retail investors and users of financial services have a range of options to enforce their rights and claim compensation when they experience damage arising from misconduct by a service provider. They can bring an individual or a collective action before a court of justice, or they can seek to resolve the disputes out of court, as considered in the next sections.

3.1. Individual Actions

Consumers can bring individual actions before the courts to resolve disputes and request damages. In Europe, this is often the most well-known option of redress for consumers, including retail investors and financial services users.[10] However, only 36% of consumers

[7]The right to an effective remedy before an impartial and independent court of justice is recognised in the International Covenant on Civil and Political Rights (Articles 2 and 14), the European Convention on Human Rights (Articles 6 and 13), the Charter of Fundamental Rights of the European Union (Article 47), and the constitutions of the member states of the European Union and other jurisdictions around the world.
[8]Case 222/84 Johnston v. Chief Constable of the Royal Ulster Constabulary [1986] ECR 1651. On consumer protection and ADR, see joined cases C-317/08, C-318/08, C-319/08, and C-320/08 Rosalba Alassini v. Telecom Italia SpA (C-317/08) and others [2010] ECR I-02213.
[9]Case C-453/99 Courage Ltd v. Bernard Crehan and Bernard Crehan v. Courage Ltd and Others [2001] ECR I-06297.
[10]"Eurobarometer Qualitative Study on Consumer Redress in the EU: Consumer Experiences, Perceptions and Choices", European Commission, 2009.

consider that it is easy to resolve disputes through the courts.[11] Barriers to access the court system include litigation costs and complex or time-consuming procedures. The problem is more acute for small claims, where litigation costs tend to exceed the value of the claim.

In order to facilitate access to justice, many member states have simplified their procedures for small claims.[12] The European Union also adopted a regulation in 2007 establishing a European small claims procedure for cross-border claims that do not exceed €2,000.[13] This procedure is available for civil and commercial matters, does not require legal representation, and is usually conducted in writing with the help of standard forms. The regulation also facilitates the enforcement of small claims judgments across borders.[14]

However, the potential of the European small claims procedure is not being fully exploited.[15] Courts and judges are often unaware of this procedure and do not always provide the forms required to file a claim.[16] Claimants, therefore, receive insufficient information and help. In addition, translation costs are sometimes high and enforcement remains frequently complex and expensive.[17]

To address some of these deficiencies, in 2013, the European Commission issued a practice guide[18] and a proposal to revise the procedure.[19] Key proposed changes include (1) raising the threshold for filing a "small claim" from €2,000 up to €10,000; (2) widening the definition of what is a "cross-border" case in order to enable more consumers and businesses to benefit from the procedure; (3) capping court fees, paperwork, and travel costs; and (4) promoting claims to be filed online and the use of video conferencing.

[11]Eurobarometer Survey 358 on Consumer Attitudes towards Cross-Border Trade and Consumer Protection 2012.
[12]See the Green Paper on Access of Consumers to Justice and the Settlements of Consumer Disputes in the Single Market: European Commission COM (1993) 576 final, Brussels (16 November 1993).
[13]Regulation (EC) No. 861/2007 of 11 July 2007 establishing a European Small Claims Procedure.
[14]Under the 2007 regulation, judgments under the European small claims procedure become directly enforceable in another member state without the need for a declaration of enforceability.
[15]ECC-Net "European Small Claims Procedure Report" (September 2012).
[16]According to the ECC-Net "European Small Claims Procedure Report" (2012), only 53% of the courts and judges in all member states were aware of the existence of the procedure; the other 47% had no knowledge about the application of this procedure.
[17]Not all countries accept the submission of a claim in a language common to both parties. Enforcing the judgment in the country of the defendant can be complex and expensive due to different enforcement procedures and need of legal assistance, which may cost the claimant more than the actual value of the claim.
[18]European Commission, "Practice Guide for the Application of the European Small Claims Procedure" (2013).
[19]Proposal for a Regulation amending Regulation (EC) No. 861/2007 of 11 July 2007 establishing a European Small Claims Procedure and Regulation (EC) No. 1896/2006 of 12 December 2006 creating a European order for payment procedure, COM (2013) 0794 final.

3.2. Collective Actions

Collective redress is a procedural mechanism that allows two or more legal claims to be bundled into a single court action.[20] Two types of collective redress can be broadly distinguished: injunctive redress, in which cessation of an unlawful practice is sought, and compensatory redress, aimed at obtaining compensation for damage suffered.

Collective actions can facilitate access to justice and provide a number of advantages in terms of costs and procedure. They are particularly useful in low-value claims and can strengthen the negotiating power of claimants. Furthermore, they may contribute to the effective management of justice by avoiding the repetition of proceedings for the same infringement.[21]

The creation of procedural mechanisms for collective actions is a relatively new phenomenon in Europe, in contrast with other jurisdictions, such as the United States. Collective actions were not part of the legal traditions of most member states but have been vigorously debated at the national and EU levels—notably, with regard to consumer and competition law.

The European Union has adopted a number of measures to facilitate injunctive and compensatory collective actions, which we describe next.

Injunctive Actions

The 1998 Injunction Directive allows qualified bodies from one country, often consumer organisations, to demand the cessation of a breach of consumer rights in another country. This procedure is available only for infringements of specific EU legislation in the field of consumer protection.[22] In 2009, it was extended to other areas, such as the distance marketing of consumer financial services.[23] However, its effectiveness has been limited because of litigation costs, length of proceedings, and limited enforcement of rulings.[24]

[20]Commission Communication, "Towards a European Horizontal Framework for Collective Redress" COM (2013) 0401 final (6 November 2013).
[21]COM (2013) 0401 final.
[22]See Directive 2009/22/EC on injunctions for the protection of consumers' interests and Directive 2002/65/EC concerning the distance marketing of consumer financial services.
[23]Proceedings stemming from this directive do not provide compensation for consumers.
[24]Report from the European Commission concerning the application of Directive 2009/22/EC on injunctions for the protection of consumers' interests, COM (2012) 635 final (11 June 2012).

The Markets in Financial Instruments Directive (MiFID) provides for its own representative procedures.[25] It requires member states to determine specific bodies that can initiate legal actions to protect the interests of consumers by demanding that the rights conferred on consumers by MiFID are upheld. Such bodies can be public authorities or consumer or professional organisations with a legitimate interest in the matter.

Compensatory Actions

As regards compensatory redress, no harmonised collective procedure exists at the European level, whereas member states have increasingly established mechanisms ranging from group actions,[26] representative actions,[27] or test case procedures[28] to procedures for skimming off profits.[29] These collective procedures vary widely among member states and considerable gaps remain in their availability, particularly at the cross-border level.

A 2009 study at the European level provided evidence on the recurrence of mass prejudice in the financial services sector and the difficulty of finding redress through collective claims.[30] A separate section in this report considers the appropriateness of collective actions and special-purpose ADR schemes to deal with instances of widespread detriment derived from the suspected mis-selling of financial products and services (see Section 4.5).

[25]Representative procedures are brought by representative organisations (e.g., not-for-profit organisations, such as consumer bodies) in the interest of consumers. See Article 74, Directive 2014/65/EU (15 May 2014) on MiFID II. Other directives include similar procedures, for example, Article 7 of Directive 93/13/EEC (5 April 1993) on unfair terms in consumer contracts. See more in Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge, UK: Cambridge University Press, 2010):459.

[26]According to a 2008 EU study on collective redress, group actions are the most common type of collective actions, and different types can be distinguished: (1) group actions, in which individual actions are grouped into one procedure, (2) actions that are brought by groups of consumers, and (3) group actions that are brought by one claimant, either an individual consumer, a consumer organisation, or a consumer ombudsman. After a favourable decision, group members can enforce their rights separately. See "Evaluation of the Effectiveness and Efficiency of Collective Redress Mechanisms in the European Union", Civic Consulting, for the European Commission (2008).

[27]In representative actions, a representative organisation obtains a judgment that this organisation can enforce. See "Evaluation of the Effectiveness and Efficiency of Collective Redress Mechanisms in the European Union", Civic Consulting, for the European Commission (2008).

[28]In test cases, a case is brought by one or more persons, which leads to a judgment that forms the basis for other cases brought by persons with the same interest against the same defendant. See the definition provided in Jules Stuyck, Evelyne Terryn, Veerle Colaert, Tom Van Dyck, Neil Peretz, Nele Hoekx, and Piotr Tereszkiewicz, "An Analysis and Evaluation of Alternative Means of Consumer Redress Other than Redress through Ordinary Judicial Proceedings" (The Study Centre for Consumer Law Centre for European Economic Law, Katholieke Universiteit, 2007):261.

[29]Skim-off procedures do not aim to compensate consumers but to skim off the profit that businesses have gained from unlawful conduct in unfair competition cases. They can be initiated by consumer organisations in Germany. See "Evaluation of the Effectiveness and Efficiency of Collective Redress Mechanisms in the European Union":7.

[30]"Study Regarding the Problems Faced by Consumers in Obtaining Redress for Infringements of Consumer Protection Legislation", Civic Consulting, for the European Commission (26 August 2008).

European Principles

In 2013, the European Commission adopted a recommendation to increase the availability of collective actions and develop a common European approach to collective redress.[31] The model proposed is markedly different from the system of class actions in the United States. The European model is focused on delivering fair compensation to claimants and, based on this principle, it discourages (1) procedures with anonymous claimants who cannot be delivered compensation, (2) lawyer fees that take away a high percentage of compensation, and (3) punitive damages because they serve instead a deterrent purpose.

EU Recommendation to Member States on Collective Redress

Recommendation 2013/396/EU is a nonbinding instrument that exhorts EU member states to provide effective mechanisms for plaintiffs to join their claims and pursue them collectively. The recommendation is formally nonbinding on member states[32] and applies to injunctive and compensatory claims through judicial proceedings or alternative dispute resolution (ADR).[33]

The recommendation provides safeguards against abusive litigation, including an admissibility test for the court to discard unmeritorious claims and a clear limit to compensation, which should not exceed the harm caused.[34] Contingency fees (lawyer fees conditional on a favourable result) are permissible but should be subject to restrictions that protect the right of the claimant to full compensation. Also, the losing party should bear all the costs of the proceedings to deter abuse.

[31]Commission Recommendation 2013/396/EU (11 June 2013) on common principles for injunctive and compensatory collective redress mechanisms in the member states concerning violations of rights granted under EU law.

[32]EU member states are not formally obliged to follow the recommendation but are given two years to implement its principles. After four years, the European Commission will assess implementation and decide whether to take further action, which may include binding legislation.

[33]The recommendation applies horizontally—that is, to the infringement of any right conferred by EU law, irrespective of the area of law in question. The recommendation explicitly mentions financial services legislation and investor protection.

[34]The European Commission and the European Parliament explicitly reject the US model of class actions. The Commission notes, "US Supreme Court decisions have started to progressively limit the availability of class actions in view of the detrimental economic and legal effects of a system that is open to abuse by frivolous litigation" (European Commission, "Communication Towards a European Horizontal Framework for Collective Redress", COM [2013] 401 final [6 November 2013]; European Parliament, "Resolution Towards a Coherent European Approach to Collective Redress", 2011/2089 [INI] [2 February 2012]).

The focus of the process should be on delivering compensation to harmed claimants. Punitive damages are thus not recommended because they serve a deterrent purpose. Furthermore, the EU recommends the use of opt-in procedures,[35] instead of opt-out procedures, because anonymous plaintiffs cannot be delivered compensation. Opt-out procedures are also discarded on the grounds that plaintiffs should be free to decide whether to litigate and be able to leave the process at any time before the final judgment.[36]

[35]Under an opt-in procedure, claimants have to expressly join the collective claim (in contrast with opt-out procedures, where the procedure is brought on behalf of all known claimants, except those who expressly opt out from the collective action). In addition, Recommendation 2013/396/EU advises that designated entities should also be allowed to bring actions of a representative nature but cannot seek profit.

[36]The EC notes that "the 'opt-in' model is used by most member states that provide for collective redress. The 'opt-out' model is used in Portugal, Bulgaria and the Netherlands (in collective settlements) as well as in Denmark in clearly defined consumer cases brought as representative actions". See EC (2013) 401 final (referenced previously).

4. Alternative Dispute Resolution

ADR schemes can provide cheaper and quicker solutions to conflicts than those offered by the courts.[37] They facilitate access to justice, in particular for claims of small to moderate value where litigation is impractical or uneconomical. Access to ADR is of great importance in retail investment markets, where relatively small claims can amount to a significant share of the wealth of the consumer.

Consumer ADR schemes have been established by both public authorities and businesses in the EU, notably in the field of financial and investment services.[38] The nature of these schemes varies considerably. For example, in the United Kingdom, one public ADR scheme covers most retail financial and investment services, whereas in Germany, a large number of private and public ADR schemes coexist with more limited remits (see Section 4.3).

To promote ADR in member states, the European Commission issued two recommendations: one in 1998 for procedures that propose (mediation) or impose (arbitration) a solution to the parties and one in 2001 for procedures that help the parties to find a solution on their own (conciliation).[39] Both recommendations provide similar frameworks of good practices, built around a number of key principles, including the principles of independence, effectiveness, fairness, and transparency (considered in the next subsection).

Many ADR schemes in Europe,[40] including those dealing with financial and investment services, adhere to the principles in the EU recommendations. However, other ADR schemes do not formally adhere to these principles or follow best practices. Several studies have highlighted the diversity in the quality of ADR in Europe and gaps in the availability of ADR in some market sectors.[41] To address this situation, the EU adopted binding legislation in 2013, explained in the next subsection.

[37] Handling a domestic dispute in court can cost on average €25,337, whereas handling a domestic dispute via ADR amounts to €472. Conservative estimates indicate that businesses can save from €1.7 billion to €3 billion and 258 days on a yearly basis if they use ADR instead of court proceedings. Alternative estimates point toward €13 billion in savings. See EC, "Impact Assessment, Accompanying the Proposal for a Directive on Consumer ADR and Regulation on ODR", SEC (2011) 1408 final (29 November 2011).
[38] SEC (2011) 1408 final (referenced previously):29, 75, 160–164.
[39] Commission Recommendation of 30 March 1998 on the Principles Applicable to the Bodies Responsible for Out-of-Court Settlement of Consumer Disputes (98/257/EC) and Commission Recommendation of 4 April 2001 on the Principles for Out-of-Court Bodies Involved in the Consensual Resolution of Consumer Disputes.
[40] The precise number of ADR schemes that adhere to the EU recommendations is unknown.
[41] "Study on the Use of Alternative Dispute Resolution in the EU", Civic Consulting, for the European Commission, 2009. See also Stuyck et al., "Analysis and Evaluation".

4.1. Directive 2013/11/EU: Principles of Best Practice in ADR

The OECD High-Level Principles on Financial Consumer Protection, endorsed by the G–20 in 2011, establish that consumer ADR should be "accessible, affordable, independent, fair, accountable, timely and efficient". These principles are best developed in Directive 2013/11/EU on consumer ADR, which requires ADR entities and procedures to comply with the following general principles and specific requirements:

- *Principle of accessibility*. There should always be an ADR entity to which consumers can have recourse, including by online means. ADR entities should refuse to deal with a given dispute only in limited circumstances (typically, consumer ADR schemes will not be open to large claims).[42]
- *Principle of expertise*. ADR agents should have the necessary knowledge in the field of ADR and a general understanding of the law. However, the directive does not require specific knowledge in the field of the dispute.
- *Principle of independence*. Conflicts of interest should be avoided. Hence, the financing of ADR should not depend directly on the will of any business or grouping of businesses.[43]
- *Principle of transparency*. Consumers should understand the operation and implications of an ADR procedure before submitting a claim (types of disputes admissible, procedural steps to follow, costs, length of the process, and effects of the outcome).[44]
- *Principle of effectiveness*. ADR should be fast and inexpensive. The directive prescribes that the procedure deals an outcome within 90 days and is free of charge or available at a nominal fee for consumers, with no obligation to retain a lawyer or legal adviser.
- *Principle of fairness.* Both parties should have the chance to express their points of view and be supplied with the arguments and evidence provided by the other party or any experts. They should also be informed about the legal repercussions of agreeing to a solution and allowed time to reflect.

[42]Such circumstances include situations when the consumer did not first attempt amicable resolution directly with the trader, the dispute is frivolous or vexatious, it has previously been considered by an ADR entity or court, it falls below or above prespecified monetary thresholds, more than one year has elapsed since the moment the consumer submitted the complaint to the trader, or it would seriously impair the operations of the ADR entity.
[43]Collegial bodies composed of an equal number of representatives of businesses and consumers are possible under the directive, with certain safeguards.
[44]Businesses shall inform consumers about the competent ADR entity on their website and contractual conditions.

- *Principle of liberty.* An agreement to submit complaints to ADR should not be binding on the consumer if it was concluded before the dispute arose in practice. A solution should not be binding either unless the parties are informed in advance and provide their acceptance.
- *Principle of legality.* If any solution is imposed on the parties, it should not deprive the consumer of any protections afforded by legal provisions that cannot be derogated or of any rights that cannot be forgone.

Directive 2013/11/EU will extend the availability of alternative dispute resolution (ADR) to any consumer-to-business dispute in any market sector, including financial services and investments.[45] It is also expected to raise the quality of existing ADR schemes and raise overall awareness of ADR. The directive does not, however, make participation in ADR compulsory or the outcome of the process binding on any of the parties, which remain decisions for member states to make.

In addition, for online sales and service contracts, the European Commission will establish a single online dispute resolution (ODR) platform, following Regulation 524/2013.[46] This tool will link all the relevant ADR entities across the EU and operate as a single point of entry for consumers and businesses. It will provide local ADR entities with an electronic case management tool and compile statistical data on the resolution of disputes.

Cross-Border ADR Claims in the EU: Practical Example

Following the 2013 ADR directive, a German retail investor who purchases units of an investment fund domiciled in Germany should receive information on the applicable ADR scheme in Germany at the time of purchase, as part of the contract of sale. When the same individual buys units of an investment fund domiciled in Luxembourg, he will receive information on the applicable ADR scheme in Luxembourg. It is assumed that the two service providers in this example have joined the relevant ADR scheme in their jurisdiction.

If a problem occurs in relation to the funds (rather than the distribution process), what is the way forward for this retail investor following the new EU rules?

[45]Such disputes concern contractual obligations stemming from sales or service contracts between a "trader" (business) established in the EU and a consumer resident in the EU. Business-to-business disputes are out of the scope of Directive 2013/11/EU.
[46]Regulation 524/2013 of 21 May 2013 on Online Dispute Resolution for Consumer Disputes.

- If the purchase was made online, the investor will be able to access both the German and Luxembourgian ADR schemes via the same point of contact: the single ODR platform.
- If the purchase was made offline, the investor may rely on FIN-NET to help him liaise with the competent ADR scheme, whether in Germany or Luxembourg (see next subsection).

Directive 2013/11/EU requires ADR entities to accept both domestic and cross-border disputes. It also requires the ADR procedure to be made accessible online, including by providing parties with the ability to submit their complaint and supporting documents online. It follows that the use of the single ODR platform or its technology could extend, over time, to disputes arising from contracts concluded offline, linking ADR schemes across Europe.

4.2. The Role of FIN-NET

FIN-NET is a collaboration tool established by the European Commission in 2001 to help resolve cross-border disputes between consumers and financial services providers.[47] Participation in FIN-NET is open to ADR schemes in member states operating in such areas as banking, payments, insurance, and investments.[48] FIN-NET directs consumers to the competent ADR scheme in cases of cross-border claims:

- Usually, cross-border disputes will be resolved by the ADR scheme where the financial services provider is established.
- Consumers residing in another country can either contact the foreign ADR body directly or seek the help of their local FIN-NET member.
- The local FIN-NET member of the consumer will send the complaint to the competent scheme in the country of the financial services provider.

The foreign ADR scheme will then attempt to resolve the dispute respecting the standards set out at the European level.[49]

[47]FIN-NET can be accessed at http://ec.europa.eu/internal_market/fin-net/index_en.htm.
[48]FIN-NET is also open to ADR schemes within the European Economic Area (EEA).
[49]See Commission Recommendation 98/257/EC on Principles Applicable to Bodies Responsible for Out-of-Court Settlement of Consumer Disputes and Directive 2013/11/EU of 21 May 2013 on Alternative Dispute Resolution for Consumer Disputes.

Participating schemes are encouraged to accept complaints in the language of the contract between consumer and service provider or in the language of previous interaction between both parties. However, this sort of language support is offered only by a small amount of FIN-NET members, which makes the network less effective in practice.[50] Furthermore, the FIN-NET website is available only in English, French, and German, which makes it difficult for many European consumers to understand the information provided.

Beyond helping consumers to access ADR across borders, FIN-NET also works to enhance the exchange of information and best practices among participating ADR schemes and to ensure these schemes respect a set of common principles and standards. In effect, participating schemes have to comply with Recommendation 98/257 (considered in previous subsections). However, FIN-NET is capable of performing only soft control regarding compliance.[51]

The ultimate goal of FIN-NET is to help strengthen the level of consumer confidence in the purchase of financial services across borders within the European Union and the European Economic Area. However, the volume of cross-border sales remains very low among retail clients, as does the number of cases processed through FIN-NET and the resources committed by participating ADR schemes to this purpose.[52]

In 2009, an evaluation report of FIN-NET showed that this network helped to facilitate consumer access to ADR schemes across borders.[53] However, it also revealed a lack of awareness about FIN-NET among consumers and gaps in the coverage of participating ADR schemes. For example, in 2012, seven member states[54] did not have a FIN-NET member dealing with investment markets.

Following the introduction of Directive 2013/11/EU, the role of FIN-NET will need to be revised to account for the strengthened minimum standards, by which all ADR schemes will need to abide in Europe. With the new directive, member states will have to control compliance with those standards and ensure that consumer ADR is available across all sectors of the economy.

[50]"Report on the Evaluation of FIN-NET", Centre for Strategy and Evaluation Services, for European Commission (June 2009).
[51]FIN-NET will demand that those ADR schemes that apply for membership adhere to the requirements in Recommendation 98/257 but has no powers of control and inspection.
[52]It is estimated that only 5%–6% of retail investors engage in cross-border purchases of financial services. See European Commission, Special Eurobarometer 373—Retail Financial Services (March 2012).
[53]"Report on the Evaluation of FIN-NET".
[54]The seven member states are Bulgaria, Cyprus, Latvia, Liechtenstein, Romania, Slovenia, and Slovakia, according to the 2012 FIN-NET activity report.

Furthermore, the directive explicitly promotes the strengthening of collaborative networks, such as FIN-NET, and requires member states to encourage ADR schemes to become members of these networks.[55] FIN-NET is thus called to play an increasingly important role in facilitating ADR in cross-border disputes and promoting awareness and best practices.

4.3. Stable ADR Schemes in Europe

Within the member states of the European Union, a wide range of ADR schemes have developed in the area of financial services. In this section, we explore key schemes for investor redress in the United Kingdom, Germany, France, Spain, Sweden, and the Czech Republic and provide some conclusions regarding the main differences and trends.

United Kingdom

In the United Kingdom, ADR is well developed and represents an important alternative to expensive judicial procedures. The Financial Ombudsman Service (FOS) was established in 2001 as an independent public ADR body to facilitate consumer redress in all financial services sectors, including investments.[56] It can award compensation for losses of up to £150,000.

The FOS procedure seamlessly integrates mediation and arbitration: Upon a complaint from a consumer, an "adjudicator" will consider the arguments of both parties and propose a solution. Most disputes are resolved at this stage (mediation). However, if one of the parties does not agree to the solution proposed, an "ombudsman" will be called on to make a final decision, which will be binding on the service provider (arbitration).[57] These decisions are based on what is considered "fair and reasonable", taking into account relevant laws and codes of practice. The FOS procedure is open only for consumers who first attempted to find a solution to their complaint directly with the service provider.

No fees are payable by the consumer to access the FOS procedure. Instead, the FOS operations are funded by the service providers through a combination of levies and case fees. In 2012–2013, the FOS expended roughly £161 million and employed 2,600 staff. Over this

[55]Recital 53, Directive 2013/11/EU on consumer ADR.
[56]Financial Services and Market Act of 2000, Part XVI.
[57]Consumers are free to accept an FOS decision, which then becomes binding on both parties, or, alternatively, pursue the matter before the courts of justice.

period, the FOS handled more than 2 million inquiries and resolved more than 223,000 claims.[58] Consumers received compensation in about 49% of cases. The duration of the procedure was less than three months in 43% of cases and less than six months in 73%.[59]

Every six months, the FOS publishes data revealing the number of complaints received and the proportion upheld in favour of consumers. It also has the power to name relevant misbehaviour by service providers. In 2012–2013, 4%–6% of the complaints concerned investment and pension products, of which 62% related to sales and advice and 30% to administration.

Germany

In Germany, consumer ADR schemes have developed at a slower pace than in the UK because court procedures are relatively cost-efficient and effective.[60] In the financial services sector, a large number of private ADR schemes have been voluntarily established by business associations. These schemes usually cover different areas of financial services, including investments, and are free of charge for consumers.[61] In addition, two specialised ADR schemes were established recently for certain investment products: one run by the national asset management association (BVI)[62] for disputes regarding investment funds and one run by the German supervisory authority (BaFin, or Federal Financial Supervisory Authority) for disputes relating to the German Capital Investment Code. Consumers can access the BaFin scheme when no other scheme is available.[63]

The ADR scheme for investment funds was set up in 2011 and is fully funded by those firms that adhere to the scheme. It consists of two ombudsmen and staff in a support office, who assist the parties in reaching a settlement and otherwise propose a solution, which is binding on the service provider for up to €10,000.[64] In 2012, the scheme decided on 797 complaints

[58]Dividing the total expenditure by the total number of claims resolved reveals an average cost per dispute of approximately £720. Dividing the total expenditure by the total number of enquiries answered reveals an average cost of approximately £76.
[59]*Annual Review of Consumer Complaints about Insurance, Credit, Banking, Savings and Investments—Financial Year 2012–2013* (London: Financial Ombudsman Service, 2013).
[60]B. Hess and R. Hübner, "Germany", in *The Costs and Funding of Civil Litigation, A Comparative Perspective*, C. Hodges, S. Vogenauer, M. Tulibacka, eds. (Oxford, UK: Hart Publishing, 2010):369.
[61]BaFin provides information about the ADR procedures at www.bafin.de. For more information on the German ADR schemes, see C. Hodges, I. Benohr, and N. Creutzfeldt-Banda, *Consumer ADR in Europe* (Oxford, UK: Hart Publishing, 2012):73 et seq.
[62]For this scheme, see www.ombudsstelle-investmentfonds.de/ihre-beschwerde.
[63]For this scheme, see www.bafin.de/EN/Consumers/ComplaintsContacts/KAGBArbitrationService/kagbarbitrationservice_node.html.
[64]Beyond this amount, the decisions of the "ombudsmen" are nonbinding for both parties.

(39 regular complaints and 758 complaints bundled in a joint procedure), of which only 4 were made in favour of the consumer. The duration of the procedure took between 1 and 10 months. Consumers keep their right to file their case before a court of justice.

The BaFin ADR scheme was also established in 2011 and offers dispute resolution services, free of charge for consumers, but does not provide legal advice. After a procedure is initiated, the scheme provides a written proposal and reasoning on how the dispute should be resolved. The parties remain free to accept the proposal or pursue the matter before the courts of justice. The annual report of BaFin notes that 30 claims were filed before the scheme in 2012 but provides no information regarding the outcomes of these procedures.

France

In France, consumer ADR is mainly offered by specialised public ADR schemes. For complaints regarding investment products, the French supervisory authority (AMF) provides a mediation service for investors, which is free of charge, confidential, and based on both law and equity.[65] The mediator will consider the written evidence submitted by both parties and may schedule meetings to clarify specific points. The mediator then proposes a recommendation, which the parties may accept or reject. The length of the ADR procedure is relatively short (normally three months). In 2012, the scheme handled 695 mediation requests, of which 30% turned out favourably (in whole or in part) to the claimant. Once again, complaining directly to the service provider is a mandatory first step.

Spain

In Spain, public ADR schemes ("consumer arbitration boards") are available, at the national and regional level, for consumer-to-business disputes. However, financial services providers very rarely agree to adhere to these schemes. In addition, the Spanish supervisor (CNMV, or Comisión Nacional del Mercado de Valores) runs a procedure to determine infringements of securities regulation following a complaint from a consumer.[66] However, the CNMV has no power to award compensation to consumers and may not even provide quantitative estimations of the losses or damages incurred by them. Following a resolution by the CNMV establishing that an infringement has taken place, service providers are expected to communicate to the supervisor whether they took remedial action: In 2012, roughly 5% of firms reported that they took such action, 23% stated that they did not take such action, and 71% remained silent. Similar schemes are in place for the banking, insurance, and pension sectors and are operated by their respective supervisors.

[65]For this scheme, see www.amf-france.org/en_US/Le-mediateur-de-l-AMF/Presentation.html.
[66]For this scheme, see www.cnmv.es/Portal/inversor/Quien-Porque-Reclamar.aspx.

Sweden

In contrast with the countries above, in Sweden there is no specialised ADR scheme for financial services; instead, a single scheme covers disputes between consumers and businesses in any sector. This "National Board for Consumer Disputes" is divided into 13 specialised departments, including 1 covering financial and investment services.[67] Consumers must complain within six months after the business rejects or does not reply to their complaint. Complaints must exceed kr200,[68] and the board may refuse to deal with cases that are complex or large in value. Both parties can submit evidence to support their claims, which will be considered by a chairperson (a lawyer with court experience) and two to four representatives of consumer and trade organisations. The average duration of the procedure is six months and closes with a nonbinding recommendation.[69]

Czech Republic

In the Czech Republic, a specialised arbitration scheme was first set up in 2003 for complaints regarding financial and investment services.[70] In 2011, a separate legal entity funded by the state called the "Office of the Financial Arbitrator" was established to administer the scheme. The scope of investment services covered by the Czech financial arbitrator encompasses collective investment schemes (as of the time of writing). The scope of investment services covered may be extended in accordance with the EU Markets in Financial Instruments Directive. The arbitrator is responsible for leading the dispute through to resolution; where agreement cannot be reached by both parties, the arbitrator is empowered by law to impose a binding decision.

Conclusion

In conclusion, a large variety of ADR schemes exist within the member states of the European Union for consumer-to-business disputes relating to financial and investment services. These schemes differ considerably in their organisation and powers: Some are public; some private. Some have broader remits; some narrower. Notably, some member states make participation in an ADR scheme compulsory for service providers, whereas in other countries, the agreement of both parties is needed to submit a dispute to ADR. Furthermore, some ADR schemes can make decisions that are binding on the business or both parties, whereas

[67]For this scheme, see www.arn.se/English/English.
[68]kr is the symbol for the Swedish krona.
[69]According to the board, its recommendations are often followed by service providers: www.arn.se/English/English.
[70]For further information, see, for example, D. Thomas and F. Frizon, "Report on Resolving Disputes between Consumers and Financial Businesses: Current Arrangements in Central and Eastern Europe", World Bank (2012).

other schemes cannot even provide quantitative estimations of the detriment experienced by the consumer—their role being limited to determining any infringement of regulatory provisions by the service provider. The effectiveness and quality of ADR schemes across Europe thus also varies widely.

Interestingly, there is a trend to establish ADR schemes that follow a horizontal approach and have jurisdiction over all subsectors of retail financial services, including investments. This approach is in line with the one followed by European legislation, since the publication of the "Communication on Packaged Retail Investment Products (PRIPs)" by the European Commission in 2009. This communication notably emphasises the need for convergence in the manner that equivalent financial services and products are treated, irrespective of whether they are originated or distributed by banks, insurers, or other intermediaries.[71]

In approximately half of EU member states, a horizontal approach is not present; instead, a number of more specialised ADR schemes address complaints in specific subsectors.[72] These schemes are sometimes divided along the traditional boundaries of banking, insurance, and securities (with reference to the main denomination or licensing of the provider). Other schemes have a narrower remit, particularly if they were created by a group of service providers or a trade association. Moreover, schemes are sometimes regional instead of national. In any event, member states will need to ensure that there are no gaps in the availability of ADR for consumers, irrespective of their geographical location, the service or product acquired, or the distributor.[73]

4.4. Stable ADR Schemes around the World

The ability to access quality ADR is of great importance to retail investors in all jurisdictions. We reviewed ADR schemes operating in the United States, Singapore, Hong Kong, and Australia. Comparing these schemes offers interesting insights regarding how to organise stable ADR systems. We provide an individual analysis of these schemes later in this report, in the section dedicated to case studies. Our main conclusions, drawn from these case studies, follow in this section.

[71]European Commission, "Communication on Packaged Retail Investment Products (PRIPs)", COM (2009) 204 (30 April 2009).
[72]According to Annex 1 (Members of FIN-NET) in the 2012 Activity Report of the Financial Dispute Resolution Network, European Commission (2013).
[73]Following the adoption of Directive 2013/11/EU, which also establishes minimum requirements to ensure the quality and effectiveness of ADR schemes (considered in Subsection 4.1).

One of the key differences among these schemes is the amount that can be claimed through ADR. The Singapore and Hong Kong schemes are open only to relatively small claims (of no more than approximately €50,000), whereas the ADR scheme run by FINRA (Financial Industry Regulatory Authority) in the United States is open to claims of any size. In a more balanced approach, the Australian "ombudsman" service has jurisdiction over claims of up to approximately €200,000.

Another key difference is the overall cost of the process and the extent to which that cost is passed on to the claimant. The lack of available data makes total costs difficult to compare across schemes. However, schemes that use external mediators or arbitrators appear to be more costly to run and more expensive for claimants than schemes running in-house operations. The total cost per claim will ultimately depend on the complexity of the case and whether it is solved at the mediation stage or has to proceed to arbitration.

The level of complexity of the process is a further important difference among schemes. The arbitration system run by FINRA incorporates such elements as discovery procedures, hearings, motions, subpoenas, examinations, and cross-examinations. As a result, the parties typically require legal advice or representation, which can carry sizeable costs. By way of contrast, the other schemes surveyed prohibit, or actively deter, legal advice or representation, sometimes including in-house legal counsel. These schemes are also simpler and avoid, as far as possible, the most costly procedural elements.

Ultimately, our case studies reveal the existence of two distinct models of ADR, both of which include mediation and arbitration: one epitomised by FINRA in the United States versus one epitomised by the Australian "ombudsman" service, which is similar to the "ombudsman" service in the United Kingdom.

- The scheme operated by FINRA caters primarily to large claims. The absence of any upper limit on the value of claims can, to some extent, justify a more complex process for arbitration, which can still deliver significant savings compared with litigation before a US court of justice.[74]
- By way of contrast, the Australian ombudsman service caters exclusively to claims of low to medium value. For that purpose, it provides a simpler process that is less costly and easier for claimants to navigate without external assistance. The schemes in Singapore and Hong Kong are similar.

[74] FINRA provides some relief for small claims, which is described in Case Study 3.

The extent to which these schemes follow the principles of quality ADR and best practices considered in Subsection 4.1 varies considerably. The Australian, Singapore, and Hong Kong schemes can be considered broadly compliant, whereas the US scheme has been the object of severe criticism, notably as regards its integrity and independence from conflicts of interest (see Annex 2, which also features a comparison of FINRA arbitration and mediation with that of the Financial Ombudsman Service in the United Kingdom).

4.5. Special-Purpose ADR Processes

Instances of mass detriment to investors do not always lend themselves well to collective actions, even when the individual claims present numerous elements in common, such as relating to the same financial instrument or intermediary. Instead, mass detriment to investors frequently requires an individual examination of each case that still takes into account their common elements:

- Collective actions are more appropriate where all claimants are affected by the same objective element—such as an abusive contractual condition, which is declared void in all circumstances—and where redress can be determined in a nearly automatic manner for each claimant.
- An individual examination of each case is more appropriate when subjective elements are at stake, such as the validity of the consent of each investor to the purchase of the financial instrument or the suitability of a given financial instrument to the characteristics and circumstances of each investor.

Instances of mass detriment to retail investors frequently arise from suspected mis-selling, where both objective and subjective elements are relevant: (1) *objective elements*, such as the complexity of the financial product sold to those investors or the origination practices followed by the relevant intermediaries, and (2) *subjective elements*, such as the knowledge and experience of the investor (his/her level of sophistication) and his/her personal preferences and circumstances, which determine the validity of consent to the purchase and the correct application of the conduct-of-business rules in the sale process.[75]

[75]MiFID requires the seller to determine that the client has the experience and knowledge to understand the risks in the transaction. Where the client does not have sufficient knowledge and experience, the seller should decline to recommend such a transaction to the client (in advised sales) or warn that the instrument is not appropriate for the client (in nonadvised sales). See Article 25, Directive 2014/65/EU (MiFID II).

In these instances, the establishment of a special-purpose ADR process can bring a fast and efficient solution to the detriment experienced by investors. Such a process can be structured to allow the individual consideration of the subjective elements of each case while providing a coordinated answer to the elements that are common to every case. In so doing, it can benefit both parties to the dispute by achieving significant time and cost savings in comparison with litigation before the courts of justice.

To illustrate the functioning of special-purpose ADR, we reviewed the schemes established in Spain and the United Kingdom to deal with instances of mass detriment to users of financial services arising from suspected mis-selling. The Spanish scheme dealt with more than €9.7 billion outstanding in hybrid instruments and subordinated debt sold by banks to households and more than 426,000 claims. The UK scheme dealt with more than 29,000 cases of interest rate hedging products (IRHPs) sold to small businesses and delivered compensation in excess of £1 million.[76] Both schemes operated during 2013 and 2014.

We provide a full analysis of these schemes later in this report, in a special section dedicated to case studies and extract in the next paragraphs the main conclusions from our observations.

Both schemes were structured to account for the elements common to every case by (1) establishing the scope of the review and the criteria to assess each case and (2) establishing the potential redress under the review and the criteria to determine the amount of compensation to each investor. In so doing, they were able to (1) increase the efficiency of the procedure by reducing the time needed to process each dispute and the costs involved in assessing individual circumstances; (2) reduce the level of uncertainty for both claimants and firms, making the outcome of the process easier to forecast; and (3) deliver compensation to claimants faster.

In our view, both schemes broadly complied with the quality principles for consumer-to-business ADR considered in Subsection 4.1: accessibility, expertise, independence, transparency, effectiveness, fairness, liberty, and legality. We benchmarked both schemes against these principles in Annex 1. However, each scheme applied each of these principles in a different manner. Comparing both schemes offers interesting insights regarding how to balance formality and flexibility when structuring special-purpose ADR.

For instance, the Spanish scheme relied on an arbitration entity (publicly financed and established on a durable basis) to deliver a final decision, binding on both parties and limiting their access to the courts of justice. The UK scheme, however, relied on a third party (an

[76]Data are as of 31 May 2014 (further detail is provided in the case studies).

"independent reviewer" nominated by the bank and approved by the supervisor) to propose a decision, which the claimant could choose to accept or reject without renouncing to pursue the matter before the courts of justice or the FOS.

Similar to the UK scheme, the Spanish scheme used third parties ("independent experts" nominated by the bank and approved by the supervisor)—albeit in a different capacity—to determine the eligibility of each case for arbitration. The use of third parties in special-purpose ADR schemes can be an efficient way to organise the process but can also undermine its integrity because of the conflicts of interest that can arise from the provision of other services.[77] A basic principle should be that a negative decision from a third party nominated by the defendant should never prevent the claimant from pursuing the matter judicially (a principle respected by both schemes).[78]

Going forward, we hope that the case studies and analysis provided in this report can serve as guidance for supervisors and firms facing similar circumstances. We would recommend national supervisors to exchange best practices as regards special-purpose ADR schemes and the European supervisory agencies—European Securities and Markets Authority (ESMA), European Banking Authority (EBA), and European Insurance and Occupational Pensions Authority (EIOPA)—to investigate the potential for a code of best practices. We would also recommend the European Commission clarify, through interpretative guidance, the application of Directive 2013/11/EU to special-purpose ADR schemes. It is our view that the directive applies not only to ADR entities established on a durable basis but also to any ADR procedure that allows the individual consideration of each case. And in any instance, we believe that the principles in the directive are materially relevant for the operation of the special-purpose ADR schemes described in this subsection.[79] We would also recommend member states endow supervisors with the power to establish and operate special-purpose ADR schemes (following the example of the United Kingdom; see Annex 6).

[77]The third party providing the service of an "independent reviewer" or an "independent expert" (typically, a professional services firm) may be affected by conflicts of interest, stemming, for instance, from the financial consideration offered by the contractor for other services, such as legal, audit, or consulting services.
[78]The UK supervisor performed a pilot phase to test the operation of the "independent reviewers" in line with the prominent role given to them in the scheme.
[79]We derive this conclusion from jointly reading Article 14 (g) and (h) and Recital 27 in the Directive.

5. Internal Complaint Management

In the chain of redress procedures (Section 2), internal dispute resolution is the first step to follow. The intervention of a third party to resolve a dispute carries costs that can be avoided if the parties find a solution on their own. Most ADR schemes thus require consumers to first complain before the service provider—that is, mediation or arbitration can be initiated only after the consumer receives an unsatisfactory response or no response to its complaint before the service provider.

Solving queries and complaints from customers is part of the day-to-day operations of service providers in all fields of activity. Depending on the scale and complexity of their operations, service providers will manage customer complaints informally or through a structured process. It is important that this process takes account of the following:

- *The level of sophistication of the consumers.* Although of course service providers should listen to the concerns from any of their clients, complaints from less sophisticated clients should be handled in a tailored manner in view of the asymmetries of information and bargaining power. This category of clients includes retail individuals and small businesses, which typically take standard contractual terms set unilaterally by the service provider. Notably, retail clients need visible and straightforward channels to submit complaints and responses that contain a motivation in plain language.

- *The level of complexity of the product.* More complex services or products require a more structured process to resolve complaints, as well as more training for the staff handling the complaints.

- *The scale of the business.* The organisation of complaint management should be proportional to the scale and complexity of each business. A separate function to manage complaints will not be appropriate or economical in all instances. Complaint management may be externalised when the scale of operations makes internal handling uneconomical. Authorities should, however, be mindful of costs for small firms, potential barriers to entry, and negative effects on competition in some market segments, which authorities can compensate for by structuring industry-wide frameworks.

From the perspective of the service provider, the internal management of complaints has two dimensions: (1) *outward looking*—that is, treating customers fairly by allowing clients to raise concerns, employing due diligence to address them, including taking remedial action and providing redress where appropriate—and (2) *inward looking*—feeding valuable information for the service provider to identify and address emerging risks and improve the quality of operations. Firms can also derive a marketing advantage from effective complaint handling.

Service providers share with their clients an interest in managing complaints internally, quickly, and inexpensively, without having to resort to ADR or court proceedings. Public authorities also have an interest in promoting the quality of internal complaint management in order to reduce the overall costs of resolving disputes in the economy. In the field of financial services, EU legislation typically requires firms to maintain effective mechanisms to handle complaints (see Annex 5), but minimum standards are only now being developed.

In late 2013, the EU supervisory authorities proposed guidelines for the handling of complaints by financial services providers (EIOPA, EBA, and ESMA).[80] These guidelines build on international principles (i.e., the OECD High-Level Principles on Financial Consumer Protection) and the experience of member states. They will be implemented through MiFID II and are expected to be incorporated in other relevant legislation over time so that equivalent standards apply to all financial service providers.

Under MiFID II, investment firms will need to establish a policy for the management of client complaints (see Annex 5). Firms will need to investigate complaints and provide reasoned responses to clients in plain language without undue delays. They will also need to inform the client about the possibility of pursuing the claim before an ADR scheme, where available. MiFID II will also require national authorities to monitor complaints and their handling.[81]

These rules are fairly high level, meaning that their practical impact will depend on their implementation by national authorities. The situation in the United Kingdom serves as a point of reference. The UK supervisor (Financial Conduct Authority, or FCA[82]) has led the way in delivering and enforcing concrete standards for complaint handling, resulting in an environment in which firms manage complaints more effectively and benchmark their capabilities in this field against their peers.[83]

[80]See EIOPA, "Report on Best Practices by Insurance Intermediaries in Handling Complaints", EIOPA-BoS-13/171 (27 November 2013); EIOPA, "Guidelines on Complaints Handling by Insurance Intermediaries", EIOPA-BoS-13/164 (27 November 2013); and Joint Committee, "Guidelines for Complaints-Handling for the Securities (ESMA) and Banking (EBA) Sectors", Final Report, JC 2014 43 (27 May 2014).
[81]European Securities and Markets Authority, Consultation Paper, MiFID II/MiFIR, ESMA/2014/54922 (May 2014):23–25.
[82]The Financial Conduct Authority (FCA) superseded the Financial Services Authority (FSA) for the supervision of conduct-of-business rules from 1 April 2013.
[83]See Financial Conduct Authority, FCA Handbook, *Dispute Resolution: Complaints (DISP)*, the detailed requirements for handling complaints and the Financial Ombudsman Service arrangements; Financial Services Authority, "Review of Complaint-Handling in Banking Groups" (April 2010); and Financial Services Authority, "Transparency—Discussion Paper", DP 13/01 (March 2013).

Emerging Best Practices in the Internal Management of Consumer Complaints by Financial Service Providers[84]

- *Senior management should take responsibility and perform oversight.* Complaint management should be an integral part of firm governance, as regards both the fair treatment of customers and the procedures to identify, manage, monitor, and report operational failures and risks.
- *Firms should handle complaint effectively and fairly.* Firms should seek to gather and consider all relevant evidence and information regarding the complaint. They should adequately train staff who handle complaints and avoid conflicts of interest, for instance, in the remuneration of such staff.
- *Firms should have transparent procedures for filing a complaint.* Firms should provide clear and easily accessible information on the complaint-handling process and accept complaints to be filed in a reasonable format for their customers—for instance, through their webpage.
- *Firms should identify recurring problems and take remedial action.* They should analyse granular and aggregate information on the root causes of complaints in order to discover any significant risks or failures, which may affect products or services different from those complained about.
- *Supervisors should play an active role.* They should use information on complaints to identify emerging risks and instances of consumer detriment. They should also work with firms to improve the quality of internal complaint handling and reduce the recourse to external ADR.

A further emerging trend is making complaint-handling data available to the public, following uniform reporting standards set by the relevant supervisor. From 2010, the FCA decided to require firms with more than 500 recordable complaints to publish their complaint figures twice a year. When evaluating the effects of this requirement, the Financial Services Authority found in 2013 that firms were increasingly taking action to address the root causes of complaints as well as improving the performance of their systems to manage complaints. It also found that potential unintended consequences had largely not materialised.[85]

[84]This list of emerging best practices is based on the studies, guidelines, and standards considered in this section.
[85]Only 6% of firms observed an increase in the likelihood that consumers would complain. Media attention had been well contextualised, although the number of complaints was not always compared with firm size. See Financial Services Authority, "Transparency—Discussion Paper", DP 13/01 (March 2013).

6. Supervisory Practices

Supervisory authorities are guardians of market integrity and compliance with the regulatory framework. They are, notably, in charge of monitoring compliance with regulatory provisions and taking actions to deter and sanction any infringements. To monitor behaviour, supervisors rely on mandatory reporting from firms and their own powers of inspection. In addition, they frequently allow consumers to raise complaints. However, supervisory procedures to handle complaints tend to pursue a punitive objective. In other words, the supervisor will seek to determine whether an infringement took place and, if so, sanction the service provider rather than arrange compensation to the client.

In effect, in many jurisdictions, the traditional approach to supervision has largely ignored redress for financial service users and investors. However, establishing efficient systems for victims to seek compensation (such as ADR schemes) is a powerful tool to encourage market discipline. Moreover, sanctions and fines typically do not reach the victims of wrongdoing, but compensation provides relief for the detriment they experienced. In Europe, punitive and compensatory procedures are typically split because of their different purposes—that is, the former pursue a general interest to punish regulatory infringements whereas the latter pursue an individual interest to gain compensation for a loss.[86]

Supervisors can play an important role in promoting or managing ADR schemes geared toward providing redress to retail investors. Some ADR schemes are embedded within the supervisory structures, whereas others are established as separate entities. In any event, supervisors and ADR schemes should work closely together because (1) ADR schemes need a good understanding of the regulatory principles and provisions relevant to assessing a case, which can be relatively complex and volatile in the field of financial services, and (2) supervisors can gain insights from ADR schemes regarding emerging trends and risks, which can prove to be valuable input to their enforcement and regulatory actions.

In addition, regulators and supervisors are called to play a role in reducing the number of complaints that reach the ADR stage by promoting the efficient internal management of complaints by the firms they supervise.

[86] Punitive damages are not part of the legal traditions in most EU member states, in contrast to the United States. See further discussion in relation to collective actions in Subsection 3.2.

6.1. Principles at the International and European Levels

The OECD High-Level Principles on Financial Consumer Protection place responsibility on authorities for ensuring that consumers have access to adequate complaint-handling and redress mechanisms. In addition, the World Bank suggests that authorities should be responsible for taking regulatory or educational measures to disable any sources of systemic complaints and publishing relevant data on complaints.[87]

Following this approach, Directive 2013/11/EU establishes an obligation for EU member states to ensure the availability and quality of ADR for consumers. They should also ensure that ADR entities and enforcement authorities in the field of consumer protection cooperate closely and exchange information. ADR entities should communicate business practices that receive repeated complaints from consumers so that preventive or remedial measures can be taken by supervisors. And enforcement authorities should provide ADR schemes with technical information relevant for the handling of disputes. In addition, the European supervisory authorities (ESMA, EBA, and EIOPA) are working toward uniform standards for internal complaint handling by service providers in the securities, banking, insurance, and pension sectors.[88] These minimum standards will take the form of guidelines for member states to apply in their respective jurisdictions on a "comply or explain" basis. The guidelines give a central role to supervisors in the monitoring of internal complaint management by service providers (see Section 5).

Cooperation between the FCA and the FOS in the United Kingdom

The FCA does not investigate individual complaints from consumers; instead, claims for compensation are dealt with by the FOS. Both bodies operate under the Financial Services and Markets Act of 2000 but are independent of each other. However, the FCA has a duty to ensure that the FOS can fulfil its functions at all times, as well as to appoint its directors, monitor its governance, and regulate such aspects as eligible complaints, time limits, maximum awards, and levies on firms (as regards the compulsory jurisdiction of the FOS over firms regulated by the FCA).

[87]World Bank, "Good Practices for Financial Consumer Protection" (June 2012).
[88]Joint Committee Final Report, "Guidelines for Complaints-Handling for the Securities (ESMA) and Banking (EBA) Sectors", JC 2014 43 (27 May 2014).

The FCA and the FOS engage on an ongoing basis to exchange information and ensure consistency in their approaches. They work together to identify emerging risks of widespread detriment for consumers in order to provide coordinated responses. Notably, the FOS provides the FCA with information about the number and types of complaints handled, and about serious shortcomings at the firm or employee level. In turn, the FCA provides the FOS with information about proposed changes to financial regulation that are relevant to the resolution of consumer disputes. The FOS and the FCA signed a memorandum of understanding in 2013.

7. Conclusions and Policy Recommendations

In this section, we summarise our main conclusions and put forward a number of policy recommendations in the European context. The first subsection considers the development of a common European approach to ADR in retail investment and financial markets, whereas the second section focuses on complaint handling and supervisory practices.

7.1. Toward a Common European Approach to ADR in Retail Investment Markets

In the previous sections, we considered alternative dispute resolution (ADR) in Europe. First, we examined the regulatory framework applicable to consumer ADR under Directive 2013/11/EU. Second, we explored a number of ADR schemes established on a durable basis in key European jurisdictions to deal with disputes in retail financial services. And last, we reviewed the use of special-purpose ADR schemes to deal with instances of widespread investor detriment in cases of mis-selling. We also surveyed and compared ADR schemes in Asia and the Americas.

In this section, we build on our analysis to propose the following policy recommendations toward a common European approach to ADR in retail investment markets: (1) ensure retail investors can effectively access ADR, (2) provide guidance on the application of Directive 2013/11/EU, (3) increase transparency to foster awareness and comparability, (4) strengthen the role of FIN-NET, (5) develop guidance on best practices, and (6) further explore the use of ADR schemes in instances of widespread investor detriment.

- **Ensure retail investors can effectively access ADR.**

  Given the importance of effective redress mechanisms to increase investor trust and participation in retail investment markets—at a time when individuals increasingly need to rely on private solutions to cater to such major future needs as retirement—we recommend the introduction of ADR schemes with compulsory jurisdiction over financial service providers.

Europe is making progress toward increasing the availability and quality of ADR schemes across consumer markets, including retail investment and financial markets. Notably, Directive 2013/11/EU will require member states to ensure that ADR schemes respect minimum standards of independence, accessibility, transparency, effectiveness, and legality.

However, more remains to be done to ensure that ADR schemes are used in practice in retail investment and financial markets. In effect, in many member states, ADR schemes are available but very rarely used because of a lack of awareness among consumers and a lack of commitment by financial service providers to participate in ADR schemes.

Directive 2013/11/EU addresses the quality of ADR schemes and their formal availability. However, it does not make participation in ADR compulsory for financial service providers or the outcome of ADR binding on any of the parties to a dispute. Therefore, unless member states provide otherwise, the effects of the directive may be very limited in practice.

Directive 2014/65/EU (MiFID II) requires investment firms to adhere to an ADR scheme for the out-of-court resolution of disputes (see Annex 5). This requirement should be extended to all sectors of retail financial services.

- **Provide guidance on the application of Directive 2013/11/EU.**

Directive 2013/11/EU follows a horizontal approach, meaning that it applies the same rules to the resolution of disputes across all market sectors, including financial services. This approach is well justified by the procedural nature of the provisions in the directive, which are indeed relevant to the resolution of disputes arising in any market sector.

However, when it comes to applying the directive to retail investment services, three elements should be further specified to account for the specificities of this market sector: (1) the definition of "consumer", which may inadvertently exclude some small retail investors, (2) the absence of any requirements regarding expertise in the field of the dispute, and (3) the responsibilities of originators and distributors.

- The directive defines "consumer" as "any natural person who is acting for purposes that are outside his trade, business, craft, or profession"; whereas, in the context of investment services, it would be more appropriate to speak of "retail investors". However, the concept of "retail client" is not explicitly defined by EU regulation; instead, it is taken to mean a client that is not a "professional" client.[89]

[89]Professional client is defined by MiFID as "a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs". In order to be considered a professional client, the client must comply with the criteria established in Annex II of the directive. Authorised or regulated entities are typically professional clients. A client classified as professional may, however, request a service provider to be afforded the level of protection corresponding to a retail client.

It follows that, when applying the directive to investment markets, the concept of "consumer" will need to be further developed. For instance, in the United Kingdom, access to the FOS is open to individual consumers, micro-enterprises (fewer than 10 employees and turnover or balance sheet under €2 million), charities with annual income under £1 million, and trusts under £1 million.[90]

- The directive requires ADR agents to possess knowledge and skills in the resolution of consumer disputes but not necessarily any expertise in the field of the dispute. However, it would be appropriate to require specific knowledge in retail investment services and their regulatory frameworks.

  In effect, retail investment products and services can adopt relatively complex and innovative structures, which would be difficult to understand for ADR schemes without specific expertise in this area. In addition, the conduct-of-business rules, applicable to the origination and distribution of these products, are sometimes also relatively complex and subject to frequent revisions.

- The directive defines "traders" as any person or entity who is acting for purposes of his business or profession. In the market for financial products and services, the concept of "trader" would hence encompass originators, distributors, and other service providers. The organisation of ADR schemes in retail financial markets should account for the different responsibilities falling on each intermediary while facilitating a single contact point for consumers seeking to resolve a dispute.

- **Increase transparency to foster awareness and comparability.**

  Uniform standards of disclosure regarding the characteristics and operation of ADR schemes are essential to raise consumer awareness and increase the accountability of ADR schemes in Europe. Directive 2013/11/EU provides a number of transparency obligations, including aggregate disclosure of the outcomes of ADR. This information could be made easily comparable across schemes and jurisdictions to monitor the differences in the quality of ADR schemes and the extent to which consumers can effectively rely on them in each market sector. Moreover, to promote the adoption of more efficient procedures and organisational structures, the disclosure obligations under the directive could extend to the total costs of operating an ADR scheme per dispute solved.

[90]Financial Conduct Authority, "Eligible Complainants", FCA Handbook, DISP 2.7.3 (http://fshandbook.info/FS/html/handbook/DISP/2/7).

From the point of view of the end user of financial services, Directive 2013/11/EU requires service providers to give information about ADR at the point of sale only if they are obliged or have committed to participate in ADR. We would recommend including this mention in standardised pre-contractual information, such as the key information document (KID) for packaged retail and insurance-based investment products (PRIIPs). We also recommend stating when the provider has not joined any ADR scheme.

- **Strengthen the role of FIN-NET.**

The role of FIN-NET could be strengthened with a formal mandate to increase the information available for both participating and nonparticipating ADR schemes in a manner that allows meaningful comparison across schemes and jurisdictions. For this purpose, FIN-NET could deliver minimum standards regarding reporting and disclosure and periodically compile and compare available information.

FIN-NET could be further strengthened by increasing the number of languages in which the service is available and staffing a permanent secretariat with the capacity to monitor the functioning of ADR schemes across the EU. In addition, FIN-NET could be tasked with developing the ODR platform for disputes arising in retail investment and financial markets, whether online or offline.

- **Develop guidance on best practices for ADR in retail investment markets.**

The comparison of existing ADR schemes across markets and jurisdictions provides useful insights into best practices beyond the principles under the consumer ADR directive. This paper contains a number of case studies to identify and illustrate best practices in ADR, such as the following:

- ▲ Maximising the simplicity, expediency, and cost effectiveness of ADR procedures—notably, by providing mediation and arbitration within one escalating procedure performed by in-house agents of the ADR scheme rather than external mediators or arbitrators.
- ▲ Encouraging ADR schemes with the broadest possible remit in order to provide a consistent level of consumer protection across investment products and services, independently of the distribution channel.
- ▲ Developing a single point of access for consumer disputes in retail financial and investment services in order to ease access, promote awareness, and avoid confusion among consumers.

  - Enabling ADR schemes to respond to consumer inquiries rather than to resolve disputes only because independent advice to consumers, regarding their rights, works to reduce the number of concerns or complaints that become formal disputes.
  - Making the jurisdiction of ADR mandatory for service providers or otherwise providing a system of incentives to encourage them to join an independent ADR scheme—notably, by making ADR cost effective for both parties—while preserving accessibility for consumers.
  - Providing guidance to service providers regarding the manner in which disputes will be resolved and the principles applied, making outcomes foreseeable so that business operations and processes can be adjusted accordingly.
  - Preventing the abuse of such terminologies as "ombudsman" and others, which can generate confusion for consumers, and improving the level of transparency on the features of each scheme in a standard format.

- **Enable the use of ADR in instances of widespread investor detriment.**

  Special-purpose ADR schemes can provide a fast and efficient solution to retail investors and users of financial services in cases of widespread detriment arising from suspected mis-selling. In effect, ADR can be structured to (1) take into account the objective elements that are common to every case and (2) allow for the individual consideration of the circumstances of each client, which is essential to determine whether the rules applicable to the sale process were infringed.

  This paper reviews two such special-purpose ADR schemes: (1) for hybrid instruments sold to households in Spain and (2) for interest rate hedging products sold to small businesses in the United Kingdom. Although each instance of mass detriment to investors is different, we find a number of best practices that can be drawn on. Section 8 contains the detailed analysis of each case, and Section 4 extracts our key observations. We would encourage endowing the relevant public authorities with the power to set up special-purpose ADR schemes in cases of mass harm arising from suspected mis-selling.

7.2. Toward a Common European Approach to Complaint Handling and Supervisory Practices

In the previous sections, we considered emerging best practices, against the evolving regulatory framework in Europe, for the internal management of client complaints by providers of retail investment and financial services. We also reviewed supervisory practices surrounding complaint handling and the coordination between supervisors and ADR schemes.

In this section, we build on this analysis to propose the following policy recommendations toward a common European approach to complaint handling and supervisory practices: (1) Apply equivalent rules to all relevant sectors of retail finance, and (2) develop a common supervisory approach, as regards the monitoring of complaint handling, cooperation between supervisors and ADR schemes, and exchange of relevant information at the European level.

- **Apply equivalent rules to all relevant sectors of retail finance.**

  ESMA, EIOPA, and EBA are working toward minimum standards for internal complaint handling by service providers in the securities, insurance, pension, and banking sectors. These or similar standards will be implemented through MiFID II and are expected, over time, to be incorporated into other pieces of financial services legislation.

  To ensure a consistent level of protection for retail investors and users of financial services, the same standards should be applied across all relevant sectors of retail finance—investments, insurance, and banking. Such standards should take into account (1) the level of sophistication of the user or investor, (2) the level of complexity of the product or service, and (3) the scale of the business of the service provider, as considered in Section 5.

- **Develop a common supervisory approach to investor redress.**

  To facilitate a comparable level of protection to retail investors and users of financial services, we would recommend ESMA, EIOPA, EBA, and national supervisors develop a common approach for (1) monitoring complaint handling by service providers, (2) cooperation between supervisors and ADR schemes, and (3) exchange of relevant information at the European level.

  - Monitoring of complaint handling by service providers.

    Aggregate data on complaint handling by service providers can provide supervisors with relevant information about emerging risks to market integrity and investor protection. The guidance by the European supervisory authorities on complaint handling envisages the possibility of reporting such aggregate data to national supervisors. We would recommend that ESMA, EBA, and EIOPA also develop a common supervisory approach to the compilation and analysis of data.

  - Cooperation between supervisors and ADR schemes.

    The case studies in this report reveal the importance of supervisory authorities and ADR schemes working closely together to identify emerging risks of widespread consumer detriment in order to provide coordinated responses and update ADR schemes on proposed changes to regulation, providing technical assistance when needed.

Directive 2013/11/EU obliges member states to ensure coordination between ADR schemes and enforcement authorities in the field of consumer protection. We would encourage the European supervisory authorities to work with national supervisors to develop a common supervisory approach as regards this cooperation.

- Exchange of relevant information at the European level.

  Building on the information gathered by national supervisory authorities through the monitoring of complaint handling by service providers and the cooperation between supervisors and ADR schemes, just considered, we would also recommend the European supervisory authorities establish a mechanism for the exchange of this information and the evaluation of emerging risks to market integrity and investor protection.

8. Case Studies

Case Study 1: Special-Purpose ADR Scheme for Households Holding Hybrid Instruments in Spain

Retail investors in Spain experienced generalised losses as a result of the decrease in the market value of hybrid instruments and subordinated debt issued by banks mostly between 2008 and 2010. Hybrid instruments, named preference shares, were characterised by a fair degree of complexity which was later judged unsuitable for non-sophisticated retail investors. Such shares had been issued in Spain since 1998 with no comparable cases of investor detriment. Yet, beginning in 2010, when the solvency position of several Spanish banks deteriorated markedly, investors experienced large losses.

Preference shares typically involve the payment of coupons over market interest rates, contingent on the solvency position of the bank. In many cases, their duration is perpetual, with discretion vested on the issuer regarding the time of repurchase. Given their hybrid character, investors can be called to bear losses if the issuer becomes insolvent. This risk materialised in 2012, when capital shortages prompted government intervention in several banking entities in Spain, among which were the largest issuers of hybrid instruments and subordinated debt to retail investors.

Several factors are intertwined in this complex case: (1) the origination of financial instruments, some of which are fairly complex, that have non-sophisticated retail investors as the target market; (2) their sale through bank branches without any analysis of suitability in most instances; (3) the use of internal matching mechanisms to keep prices artificially high;[92] and (4) a supervening process of bank restructuring, which contemplated the imposition of losses on holders of hybrid instruments by a newly created resolution authority. The second and fourth aspects are the most relevant here.

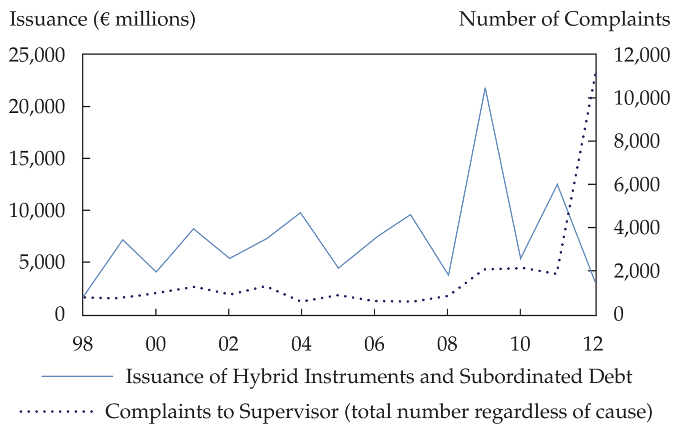
[92] Comisión Nacional del Mercado de Valores (CNMV), "Informe sobre la operativa de case de operaciones entre clientes de instrumentos híbridos" (26 September 2011); CNMV, "Informe razonado sobre el case de operaciones sobre participaciones preferentes y deuda subordinada emitidas pro Bancaja y Caja Madrid, entidades integradas en Bankia" (11 February 2013).

Inadequate Selling Practices

As mentioned, hybrid instruments were sold in Spain since the end of the 1990s by financial and nonfinancial corporations and resulted in no instances of investor detriment comparable to the one at stake. A total of 461 issuances took place between 1998 and 2012, totaling more than €115 billion subscribed by more than 3 million individuals and entities.[93] For banks, these instruments were eligible to fulfil regulatory capital requirements, making them an attractive venue for financing—in particular, when other sources tightened, which happened from 2007.

From 2008 to 2010, banks increased the pace of emissions and their targeting of retail investors. As confidence in the Spanish banking sector suffered, wholesale financing evaporated, prompting banks to tap retail markets. In 2009, banks issued more than €21 billion in hybrid instruments and subordinated debt, more than five times the average annual issuance in the previous decade. In 2012, when the extent of detriment to investors became clear, complaints to the supervisor also increased fivefold, nearing 11,000 complaints. **Figure 2** illustrates the evolution of issuances and complaints.

Figure 2. **Evolution of Issuance of Hybrid Instruments and Complaints to the Supervisor**



Source: Comisión de Seguimiento and CNMV.

[93]Comisión de Seguimiento de Instrumentos de Capital y Deuda Subordinada, "Informe sobre la comercialización de instrumentos híbridos de capital y deuda subordinada", Real Decreto-Ley 6/2013 de 22 de Marzo, Madrid (primer informe trimestral), 17 March 2013.

Banks and bank-like "*cajas de ahorros*" sold these instruments to households and small businesses through their distribution networks, relying on existing relationships between clients and branches. In reviewing sale practices *ex post*, the CNMV observes three main elements that call into question the fairness of distribution practices vis-à-vis clients:[94]

- In almost all cases, hybrid instruments and subordinated debt were sold to retail clients without any analysis of suitability,[95] meaning that no formal investment advice was delivered by the bank to the client, despite the complexity of many of these instruments.
- Most clients bought these instruments despite being warned in the contractual documentation that they were not appropriate[96] for them, meaning that banks were aware that these investors were unlikely to understand the risks involved in holding these instruments.
- Many clients complained that branch employees and managers gave them oral information that either contradicted documented contractual information or amounted, in their view, to a nondocumented personal recommendation without a suitability assessment.

These three elements are not sufficient to prove mis-selling as defined as the contravention of legal requirements for the sale of financial instruments as provided mainly by MiFID.[97] There are notable, inherent difficulties in proving the provision of contradictory oral information. However, despite being nonconclusive, these elements are indicative of banks and their agents sometimes exploiting the trust of clients or their lack of sufficient knowledge and experience (i.e., behavioural biases and asymmetries of information).[98]

[94]Comisión de Seguimiento de Instrumentos de Capital y Deuda Subordinada, "Informe sobre la comercialización de instrumentos híbridos de capital y deuda subordinada", Real Decreto-Ley 6/2013 de 22 de Marzo, Madrid (primer informe trimestral), 17 March 2013.
[95]MiFID II, Article 25.2, Directive 2014/65/EU.
[96]MiFID II, Article 25.3, Directive 2014/65/EU.
[97]Directive 2014/65/EU (MiFID II) of 15 May 2014 on markets in financial instruments (recast of Directive 2004/39/EC, MiFID I).
[98]Bank employees and managers may, however, have acted in good faith without appropriate understanding of the materiality of the risks incurred by investors and the likelihood of worsening economic conditions and bank solvency positions. They may have been acting within poorly devised internal policies for the origination and distribution of financial instruments of this level of complexity to non-sophisticated retail investors.

Bail-In of Retail Investors

In 2012, Spain signed a memorandum of understanding (MoU) on financial sector conditionality agreeing to the engagement of the European Financial Stability Facility to help restructure its banking sector. Following the principle of burden sharing in order to minimise the costs for taxpayers, the MoU established that "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 [by means of] Subordinated Liability Exercises (SLEs)".[99]

Under the SLEs, holders of instruments issued by entities that received state aid were allocated losses by the resolution authority (Fund for Orderly Bank Restructuring, or FROB). In addition, the FROB set up a special-purpose arbitration mechanism for the clients of entities where it held a majority stake (Bankia, CatalunyaCaixa, and Novacaixagalicia, or NCG). The arbitration process had two main purposes: (1) to give retail investors the opportunity to seek compensation for the principal invested, free of charge and effectively and (2) to quickly clarify the extent of the losses that would ultimately fall on taxpayers.[100]

More than €9.7 billion outstanding in hybrid instruments and subordinated debt was opened to arbitration. In total, the three entities concerned received more than 426,000 petitions for arbitration (80% of clients concerned and 69% of outstanding). The results of the arbitration process are detailed in **Table 1**. Up to May 2014, the "independent experts" had accepted the petitions received from nearly 303,000 clients, equivalent to nearly €3.3 billion. The process was expected to be completed by the end of June 2014.[101]

[99]European Commission, "Memorandum of Understanding on Financial-Sector Policy Conditionality" (20 July 2012).

[100]A third objective was to increase legal certainty for holders of the instruments concerned, following the introduction of legislation permitting the imposition of losses on holders of hybrid instruments and subordinated debt by a simple administrative decision emanating from a resolution authority (the newly created FROB). This amounted to a change in the legal framework applicable at the time of issuance, which only permitted the imposition of losses by judicial order in the framework of a liquidation process before a court of justice. From a factual perspective, the situation was equivalent because absent intervention from the FROB, the entities affected would have entered liquidation. A fourth objective was to help quickly reestablish normal relationships between the banking entities concerned and their clients so as to protect the value of the franchise in the interest of taxpayers.

[101]Comisión de Seguimiento de Instrumentos de Capital y Deuda Subordinada, "Informe sobre la comercialización de instrumentos híbridos de capital y deuda subordinada", Real Decreto-Ley 6/2013 de 22 de Marzo, Madrid (cuarto informe trimestral), 25 April 2014.

Table 1. Summary of Outcomes of the Arbitration Procedures for Holders of Hybrid Instruments and Subordinated Debt Issued by Entities Controlled by the FROB

	Open to Arbitration		Petitions Received		Petitions Admitted ("Independent Expert")		Positive Resolution (Arbitration Board)*	
	€ (billions)	Clients	€ (billions)	Clients	€ (billions)	Clients	€ (billions)	Clients
Bankia (BFA)	6.23 (100%)	294,905 (100%)	4.04 (65%)	229,931 (78%)	2.30 (37%)	176,655 (60%)	1.76 (28%)	152,330 (52%)
Catalunya-Caixa	1.71 (100%)	122,585 (100%)	1.27 (74%)	102,698 (84%)	0.47 (28%)	68,853 (56%)	0.31 (18%)	34,378 (28%)
NCG	1.83 (100%)	116,660 (100%)	1.45 (79%)	93,899 (81%)	0.50 (27%)	58,017 (50%)	0.50 (27%)	58,016 (50%)

*The procedure before the arbitration board is not yet finalised but is expected to endorse nearly 100% of the petitions admitted by the independent expert.

Note: Data are as of 25 April 2014.

Source: Comisión de Seguimiento and CNMV.

Independent Arbitration

The CNMV has the power to resolve consumer-to-business disputes within its jurisdiction, determining whether an infringement of conduct-of-business rules has occurred. It may also open a separate procedure to impose fines on the business committing the infringement. However, the CNMV has no power to award compensation to consumers and may not even provide quantitative estimations of the losses or damages incurred by them. In other words, an entity concerned by an infringement decision may refuse to compensate its client. Only a court of justice may award compensation unless the entity voluntarily agrees to participate in ADR.

The resolution of disputes by the supervisor has limited effects. Only a small minority of firms report taking remedial action after being notified of a supervisory decision upholding the position of the client. In 2012, only 5.1% of firms communicated to the CNMV that they took remedial action, 22.9% communicated that they did not take such action, and 71.2% did not communicate anything to the supervisor. The process appears, therefore, ineffective for investors seeking to obtain compensation.[102]

[102]Comisión Nacional del Mercado de Valores (CNMV), "Atención de reclamaciones y consultas de los inversores – Memoria 2012" (2013).

In this context, and in view of the large number of holders and volume of hybrid instruments and subordinated debt outstanding, it was judged appropriate to create a special-purpose arbitration process with compulsory participation for the issuers concerned. The arbitration process was ad hoc because (1) it was accessible only for retail holders of a closed list of instruments, and (2) it had its own rules of procedure, devised in view of the specific circumstances of the case. Whether the status of retail client applied to each claimant was determined by applying MiFID rules on client categorisation.[103]

Restrictions on the Scope

The scope of the arbitration process was restricted, thereby defining the object of the dispute, the criteria to assess the case, the maximum recoverable amount, and the method of calculation.[104]

- The object of the dispute was limited to establishing whether, at the time of purchase, the consent of the client was valid—that is, whether any circumstances might have clouded the judgment of the client and invalidated his or her consent to the purchase. When assessing this factor, the parties to the dispute and the arbitrators referred to a list of basic criteria.
- The maximum recoverable amount was limited to the principal subscribed plus interests, as if the principal would have been held in a bank deposit. Any coupons perceived by the investors were discounted. Each client was informed in writing about the maximum recoverable amount in his or her case, before accepting to bring the dispute before an arbitrator.

Introducing restrictions on the scope can be a valid strategy in structuring an ADR process because they can (1) increase the efficiency of the procedure by reducing the time needed to process each dispute and the costs involved in assessing individual circumstances, (2) deliver compensation to claimants faster, (3) reduce the level of uncertainty for both parties who know *ex ante* the circumstances that will be assessed and the maximum monetary amounts at stake. It follows that restricting the scope can encourage participation in ADR because it makes the outcome of the process easier to forecast and the overall costs linked to the procedure smaller.

Basic Criteria to Assess Case

The list of basic criteria to consider the merits of the case plays an important role in preserving the integrity of the ADR procedure. In the present case, a special-purpose entity was set up in order to draft this list of criteria and monitor the arbitration process. This

[103] Annex 2, Directive 2014/65/EU (MiFID II).
[104] Junta Arbitral Nacional de Consumo – Instituto Nacional de Consumo, "Informacion de Interés para Consumidores y Usuarios – Arbitraje de Preferentes y Subordinadas de Bankia" (2013).

entity (Comisión de Seguimiento) was formed by representatives of the CNMV, consumer protection authorities, and consumer associations. Given the specific circumstances of the case, the FROB and the ministry of finance were also members of this entity.

The list of basic criteria referred to five factors : (1) lack of capacity to contract—for instance, when the client was a minor; (2) important inaccuracies or omissions in the contractual documentation; (3) missing or incorrect information about the product features and risks, including the provision of additional information inconsistent with contractual documentation; (4) lack of client categorisation or incorrect assessment of suitability or appropriateness; and (5) the weight of the investment in the wealth of the client and the lack of other relevant sources of income. These criteria are indicative of mis-selling and may be relevant for other ADR procedures (see Annex 3 for full list).[105]

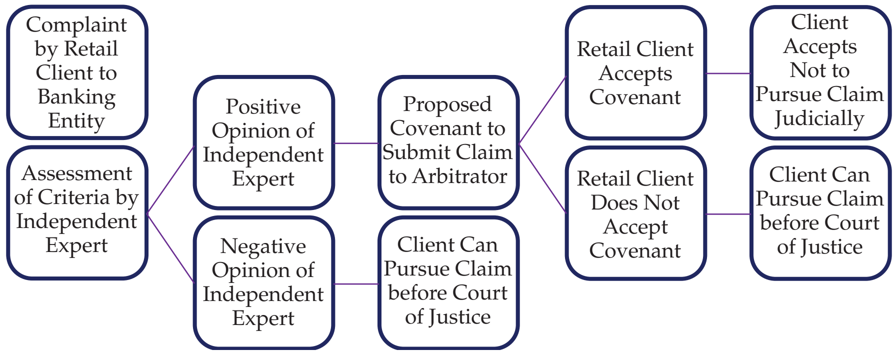
Intervention of Independent Expert

An independent expert was a third party, appointed by each banking entity to assess the concurrence, in each individual claim, of the basic criteria determined by the entity monitoring the arbitration process. The chosen experts were KPMG, Ernst & Young, and PricewaterhouseCoopers—all of which are international professional services firms. These firms also calculated the maximum recoverable amount for each claim by applying a preset formula. It is unclear whether the monitoring entity had any specific policy or procedure in place to mitigate potential conflicts of interest.

As represented in **Figure 3**, the independent expert issued an opinion. A positive opinion was followed by a proposed covenant to submit the claim to arbitration. All covenants followed the same standard, publicly available model. The client was free to accept or reject this covenant, which stated the maximum recoverable amount. If the client accepted the covenant, it renounced to pursue the dispute before a court of justice. It is uncertain, however, whether the client could pursue judicially any consequential damages not covered by the covenant.

[105]FROB, "Publicidad de los criterios básicos determinados por la Comisión de seguimiento de Instrumentos Híbridos y Deuda Subordinada – Nota de Prensa" (17 April 2013).

Figure 3. Intervention of Independent Expert in Initial Phase of Procedure



Source: Based on information from FROB, Comisión de Seguimiento, and Junta Nacional Arbitral de Consumo.

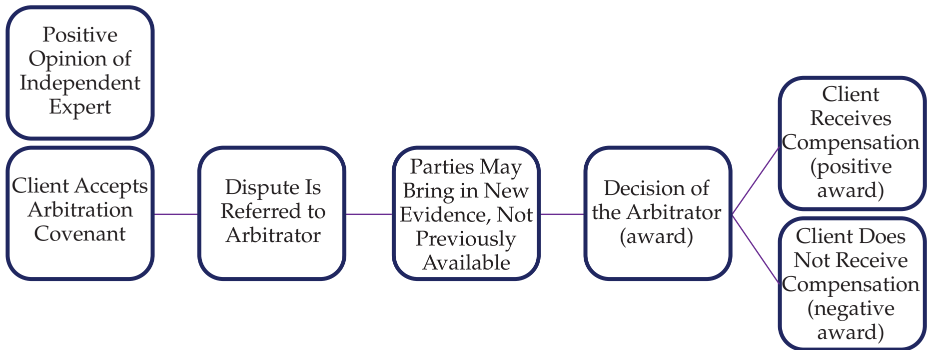
Arbitration Procedure

Disputes that received a positive opinion from the independent expert and in which the client agreed to the arbitration covenant were resolved by an independent arbitrator. All disputes were resolved by independent ADR entities, publicly financed and respecting the principles of Commission Recommendation 98/257/EC on consumer ADR (see Section 4). Arbitrators were legal experts and received additional training on the subject matter of the disputes.

Figure 4 represents the arbitration process. The arbitrage was in law, not equity. Arbitrators chiefly assessed the concurrence of the basic criteria determined by the monitoring entity, with reference to the opinion of the independent expert and supporting evidence. Claimants were given the opportunity to be heard, but the intervention of an independent expert served to reduce the need for hearings, speeding up the process.[106]

[106]In sum, the arbitration process was devised to review the opinion of the independent expert and give legal enforceability to the award of compensation to the investor. This resulted in a fast and efficient procedure but denied, to those clients who received a negative decision from the independent expert, the opportunity to be heard before the arbitrator. Nevertheless, the action of the independent experts could be considered, to some extent, equivalent to an arbitration procedure.

Figure 4. Arbitration Procedure after Positive Opinion of Independent Expert



Source: Based on information from the FROB, Comisión de Seguimiento, and Junta Nacional Arbitral de Consumo.

Case Study 2: Special-Purpose ADR Scheme for Small Businesses Holding Interest Rate Hedging Products in the United Kingdom

Small businesses in the United Kingdom experienced widespread detriment following the purchase of IRHPs sold by banks in conjunction with loans and other lending arrangements. In 2012, the UK supervisor (which was then the Financial Services Authority, or FSA) conducted an investigation into the sale of these instruments to business clients and found evidence of poor origination and sales practices. Following this investigation, the FSA worked with a group of banks[107] to set up an ADR process that would allow non-sophisticated clients to seek redress expediently and free of charge.[108] The "review" was managed by the banks concerned under the control of third parties (i.e., independent reviewers). The FSA made public the projected and actual progress of the review of each bank, which contributed significantly to the speed of the process.

[107]The bank group consisted of Barclays, HSBC, Lloyds, RBS, Allied Irish Bank, Bank of Ireland, Clydesdale and Yorkshire banks, Co-operative Bank, Northern Bank, and Santander UK. The liquidators of the Anglo Irish Bank and the Irish National Building Society cancelled the participation of these entities in the review.

[108]Banks also committed to consider suspending payments under IRHPs, for businesses in financial difficulties, and keeping existing lending conditions, pending review of their cases.

Under the Financial Services and Markets Act of 2000, the UK government has the power to authorise the UK supervisor to establish and operate a scheme for the "review" of past business when a widespread failure to comply with applicable rules results in losses for third parties (see Annex 6). This scheme will determine both the extent of the compliance failures and the compensation to be paid by service providers to any third parties.[109] The UK authorities did not formally use these powers on this occasion.

IRHPs are derivatives that can serve to manage interest rate fluctuations in an underlying loan. They can, for instance, limit the interest rate paid if market rates exceed a threshold. There are, however, multiple forms of IRHPs, including swaps, caps, and collars. The FSA found evidence of serious shortcomings relating to (1) the complexity of some IRHPs relative to the sophistication of some clients; (2) poor disclosure of exit costs, which sometimes exceeded 40% of the value of the loan; (3) irrational over-hedging, where the amount or duration of the hedge exceeded the horizon or value of the loan; and (4) poor selling practices driven by monetary and other incentives for sales staff and managers.

The review was structured in three phases: (1) assessment of the level of sophistication of the client, (2) assessment of the compliance by banks with legal requirements regarding the origination and sale of financial products to non-sophisticated clients, and (3) determination of fair and reasonable redress. Each of these phases was conducted individually for each eligible customer who opted into the review process. **Figure 5** represents the five key steps of the review process graphically.[110]

Figure 5. Phases of the Review Process

Source: Based on information from the FCA.

[109] Financial Services and Markets Act of 2000, Section 404.
[110] Extensive information about the review is found at www.fca.org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products.

Restrictions on Access

Access to the review was restricted in favour of non-sophisticated investors. The FSA established a test for banks and independent reviewers to determine whether a client was non-sophisticated:

Step 1. Determine whether the client fell, at the time of sale, within the definition of "retail client" under national law, transposing (i.e., bringing into national law) MiFID. Nonretail (professional) clients were out of the scope of the review.

Step 2. Determine whether the (retail) client could be classified as non-sophisticated by excluding those clients who were

- subjectively sophisticated—that is, having the necessary knowledge and experience to understand the IRHP purchased,[111] or
- objectively sophisticated—that is, exceeding the thresholds provided under national company law for the definition of small businesses.[112]

In addition, access to the review was made preferential for more complex forms of IRHPs. The FSA established three broad categories of IRHPs for the purpose of the review based on the features and complexity of the different structures. This categorisation was also informed by the observations of the FSA regarding different forms of client detriment and shortcomings in sales practices:

- Category A: Structured collars (most complex products under review)
- Category B: Simple collars, swaps, and all other IRHPs
- Category C: Interest rate caps (least complex products under review)

Structured collars (Category A) were judged too complex to be sold to non-sophisticated investors, meaning that they should not have been originated with such investors in mind as the target market. Plain-vanilla collars are noncomplex IRHPs that limit the impact of fluctuations in interest rates to a predetermined range. However, structured collars have additional features whose benefits and risks are difficult to understand. The holder of a structured collar may end up paying additional amounts if market interest rates fall below

[111] The bank would have to prove subjective sophistication of a given client to the independent reviewer.
[112] Detailed information about the sophistication test is found at www.fca.org.uk/your-fca/documents/fsa-irs-flowchart.

the bottom of the range. These products were judged to incorporate an element of speculation that is generally unsuitable for non-sophisticated clients seeking to mitigate, for a fee, the potentially adverse impact of interest rate rises on loan payments.

Other forms of IRHPs (Category B) include swaps and simple collars, whose structures are typically less complex. These IRHPs fell, nevertheless, within the review because of the detriment experienced by clients as a result of poor selling practices, such as (1) the provision of incomplete, unfair, or misleading information; (2) transactions documented as nonadvised sales in which advice-like recommendations were given orally to clients or in which the seller generated confusion for the client as to the regime applicable; and (3) poor application of the suitability and appropriateness tests. Interest rate caps (Category C) were, in view of the characteristics of their structuring, the least likely to have generated consumer detriment as the result of poor selling practices.

Based on this categorisation, the review process was structured to give preference to the holders of the most complex forms of IRHPs.

- Holders of structured collars accessed the review automatically without any need to opt in. Once the client was assessed as non-sophisticated (Phase 1), the assessment of non-compliance was omitted (Phase 2), and the cases proceeded directly to the determination of redress (Phase 3).[113]

- Holders of simple collars, swaps, and other IRHPs (except caps) were invited to join the review if determined to be non-sophisticated.

- Holders of caps were not invited to join the review and would need to actively complain to their bank if they had experienced detriment due to mis-selling.

Restrictions on Scope

The review process was designed to restrict the object of the dispute and the criteria to assess the merits of each case. It did not restrict compensation, which could encompass consequential losses, including lost profits. It did, nevertheless, provide guidance to determine "fair and reasonable" redress:

[113]The omission of Phase 2 (non-compliance with the rules applicable to selling practices) reveals that participating banks and the FSA agreed that structured collars were generally unsuitable for non-sophisticated clients and therefore should not have been proposed to such clients at all.

The object of the dispute was limited to assessing whether the bank had failed to comply with legal requirements, applicable at the time of purchase, on the origination and sale of products. It was thus an ADR process in law rather than equity. The FSA provided guidance regarding the applicable rules and relevant aspects to consider (see Annex 4). It did not, however, provide a specific test. Banks and independent reviewers were to consider "whether taking into account all the circumstances, it was reasonable to conclude that the customer could have understood the features and risks of the product".[114] More than 88% of assessed sales were determined to be non-compliant. **Table 2** provides an overview.[115]

Table 2. Incidence of Non-Sophistication and Non-Compliance as Assessed during the Review Process

	Category A Structured Collars	Category B Other IRHPs	Category C Interest Rate Caps
Review population	2,111	26,175	7,380
Clients assessed for sophistication	All (automatic)	All (automatic)	1,277 (who actively complained)
Clients determined to be non-sophisticated	1,601	16,246	1,117
Clients who opted in	All (automatic)	13,625	All (automatic)
Sales assessed as non-compliant	1,605 (automatic)	13,060	

Note: Data are as of 31 May 2014.

Source: Based on information from FCA.

The FSA also provided guidance on how to determine "fair and reasonable" redress, defined as putting each client back in the position he or she would have been in if the individual instance of non-compliance had not occurred.[116] Redress comprised two elements: (1) "basic redress", including a full or partial reimbursement of amounts paid under the initial IRHP, and (2) compensation for consequential losses consisting of either 8% a year simple interest or proved lost profits.

The determination of "basic redress" depended on whether the client, in the absence of the non-compliance, would have purchased the same IRHP (no compensation), a different IRHP (compensation of the difference in payments), or no IRHP (full compensation). If

[114]FSA, "Interest Rate Hedging Products – Pilot Findings" (March 2013).
[115]The progress of the review is found at www.fca.org.uk/static/documents/aggregate-progress.pdf.
[116]FSA, "Interest Rate Hedging Products – Pilot Findings" (March 2013). More information can be found at www.fca.org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products.

the client experienced no loss, there would be no redress. For instance, in cases of over-hedging, the natural solution would be to substitute the original IRHP with another one matching the amount and duration of the loan. Any alternative product had to be simple (a plain-vanilla swap, collar, or cap) and could not have break costs larger than 7.5%.

Interests were applied to the sum determined as basic redress with two purposes: (1) to compensate the opportunity cost of being deprived of money and (2) to compensate other consequential losses without having to prove them, thereby speeding up the review process and reducing procedural costs. To fulfil this second purpose, the rate was positioned at 8%, well above the market rate for traditional bank deposits. Clients were free to renounce to these interests and instead claim lost profits. The FSA provided guidance on assessing lost profits as well as information for clients regarding such aspects as the burden of proof.

Table 3 summarises the redress outcomes of the review process. On 31 May 2014, 6,726 customers had accepted a redress offer and a total compensation of £1,059 million had been paid out. Full tear-up of the contract[117] was offered in 48.6% of cases and accepted in 73.4% of cases, whereas an alternative product was offered in 43.7% of cases and accepted only in 30% of cases.[118]

Table 3. **Outcomes of the Review Process in Terms of Redress**

	Redress Proposed	Redress Accepted
Full tear-up (+8% a year simple interest)	6,685	4,909
Alternative product—cap (+8% a year simple interest)	3,858	1,534
Alternative product other than cap (+8% a year simple interest)	2,147	283
Consequential loss (instead of 8% a year simple interest)	NA	NA
No redress	1,046	—

Notes: Data are as of 31 May 2014. NA is "not applicable".

Source: Based on information from the FCA.

[117]In a full tear-up, the contract is deemed null and void. Compensation will thus put the client back in the position that the client would have been if the contract had never existed.

[118]The progress of the review can be found at www.fca.org.uk/static/documents/aggregate-progress.pdf.

Independent Reviewers

The review process was agreed on by the FSA and a group of banks.[119] The process was thus conducted by the banks concerned but under the control of third parties (called "independent reviewers"). The Financial Services and Markets Act of 2000 allows the UK supervisor to appoint "skilled persons".[120] Although this power was not formally used on this occasion, the FSA conducted an approval process of the independent reviewers appointed by the banks in order to control for conflicts of interest, skills, and expertise (with regard to both the IRHPs and small businesses).[121] The FSA required the appointment of a second reviewer in case of conflicts of interest with an individual client.

Independent reviewers were in charge of controlling, individually for each case, the correct application of the FSA guidance for each of the phases of the review process (assessment of sophistication, assessment of non-compliance, and determination of fair and reasonable redress). When the opinions of the bank and the independent reviewer diverged, the opinion of the latter was to prevail. It follows that these independent reviewers ultimately acted as a form of arbitrators between the bank and its clients—that is, the parties to the dispute.[122]

Pilot Phase

In 2012, the FSA and a group of banks conducted a pilot review of 173 sales to non-sophisticated clients in order to test the extent of non-compliance with regulatory requirements. In addition, 133 cases were separately examined to test the application of the sophistication test initially proposed by the FSA. This pilot phase served to improve the FSA's initial approach of the conduct of the review and to observe the interactions between banks and independent reviewers. Based on the results of the pilot phase, the FSA introduced changes to the sophistication test and created a set of redress principles.[123]

Financial Ombudsman

Clients who opted into the review retained their right to seek redress before the FOS if their claim was not satisfied under the review. They also retained their right to launch proceedings before a court of justice, including for consequential losses not compensated under

[119]See Footnote 109.

[120]Financial Services and Markets Act of 2000, Section 166.

[121]"Independent reviewers" were mostly professional services firms. The FSA looked at such aspects as the fees generated by these firms from banks and the work carried out for them, as well as any interest of these firms in the solvency of the clients under the review (e.g., involvement in an insolvency procedure).

[122]FSA, "Interest Rate Hedging Products – Pilot Findings" (March 2013).

[123]FSA, "Interest Rate Hedging Products – Pilot Findings" (March 2013).

the review. The rules on standing before both these instances naturally applied in the usual manner. At the time of the review, access to the FOS was open only to claimants fulfilling the definition of micro-enterprise (fewer than 10 employees and annual turnover of balance sheet below €2 million). In other words, only the smallest non-sophisticated clients could have accessed the FOS. Given the large number of cases, the FSA agreed to create a special-purpose ADR mechanism (the "review" process), thereby extending to all non-sophisticated claimants the access to effective ADR.

Case Study 3: FINRA Mediation and Arbitration in the United States

FINRA is a private organisation granted the status to serve as a self-regulatory organisation in the United States. FINRA runs the largest ADR framework in the world for investors in securities.[124] It has jurisdiction over all registered entities (virtually all brokerage firms), which are obliged to participate in arbitration at the request of their customers. Most brokerage contracts, however, also oblige investors to bring any disputes before FINRA arbitration and relinquish their rights to court proceedings before the dispute materialises. Arbitration awards cannot generally be appealed before the courts either.

In addition to arbitration, FINRA runs a mediation scheme. Whereas an arbitrator will deliver a decision (award) binding on the parties, a mediator will only help them find an agreement and settle the dispute. FINRA invites investors to complain first to their brokers, but this is not a mandatory first step unless the brokerage contract provides otherwise. FINRA also runs a separate complaint programme, whose purpose is to punish non-compliance by firms with regulatory requirements rather than allow customers to seek compensation.

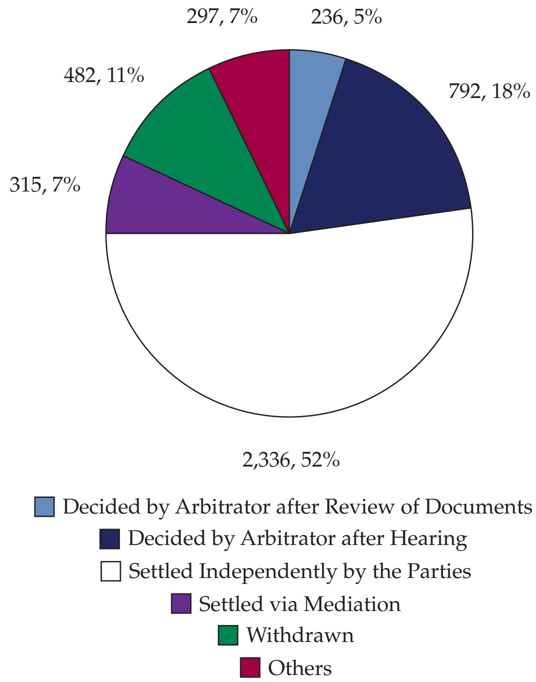
FINRA arbitration mirrors the adversarial judicial process in the United States. It is open for claims of any size and combines such elements as discovery procedures, hearings, motions, subpoenas, and examinations and cross-examinations of witnesses and expert witnesses.[125] It is thus a modular and complex process, which most individuals cannot navigate without legal advice and representation. Cases take from 12 to 16 months to

[124]More information on FINRA arbitration and mediation is available at www.finra.org/ArbitrationAndMediation/index.htm. See also FINRA Investor Education Foundation and Pace Law School Investor Rights Clinic, "Investor's Guide to Securities Industry Disputes: How to Prevent and Resolve Disputes with Your Broker" (2013).

[125]See the FINRA code of arbitration procedure for customer disputes: http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4096.

close on average, depending on whether a hearing is held. Approximately 78% of non-settled cases involve at least one hearing session. However, most cases are settled, as **Figure 6** indicates.[126]

Figure 6. **US Arbitration Cases Closed in 2013**



Source: FINRA.

The costs of arbitration may exceed several thousands of dollars per case. Charges by FINRA include filing fees, prehearing process fees, hearing process fees, and hearing session fees.[127] Most parties also have to pay for legal advice and representation. Still, the total

[126]More statistics can be found at www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics.

[127]The filing fee for customers varies between $50 (for claims under $1,000) and $1,800 (for claims over $1 million) and for firms between $225 (for claims under $1,000) and $3,700 (for claims over $5 million). The prehearing process fee is $750 for claims over $25,000. The hearing process fee varies between $1,000 (for claims between $25,000 and $50,000) and $5,500 (for claims over $5 million). The hearing session fee varies between $50 (for claims under $2,500) and $450 (single arbitrator) or $1,200 (panel of three arbitrators) for claims over $500,000 per hearing session lasting no more than four hours.

cost and duration of arbitration tends to be significantly lower than adjudication before a US court of justice. Although the fees charged by FINRA are proportional to the size of the claim, the process is unlikely to be economical for relatively small claims.

The parties may decide to pursue mediation at any stage during arbitration. Almost 60% of cases initially submitted to arbitration are settled, approximately 12% of which with the help of a mediator. FINRA refunds at least 50% of the filing fees for cases settled more than 10 days in advance of the first hearing. The costs of arbitration operate as a powerful incentive for parties to accept mediation; 80% of cases that go to mediation end in a settlement.

FINRA mediation is less expensive than arbitration.[128] It takes place in person and typically lasts for one day, when the parties meet separately and jointly with the mediator, who helps them come to a settlement but cannot propose one himself. FINRA assists the parties in enforcing any settlement reached through mediation. Even if it does not lead to a settlement, mediation can prove useful for the parties to improve their understanding of the case before they resume or start arbitration. The costs for consumers attending FINRA mediation, however, are above those of similar ADR schemes in other jurisdictions.

Claims under $50,000 are eligible for simplified arbitration and mediation by phone. Simplified arbitration involves only one arbitrator (instead of a panel of three) and no hearings unless the claimant requests one.[129] Mediation by phone is free of charge for claims of less than $25,000 and $50 per hour for claims between $25,000 and $50,000. It is only available for parties in an active arbitration case, which implies its own costs: In a best case scenario, for a claim of less than $25,000, the investor would only pay $125 (as a filing fee for arbitration after a partial refund). FINRA also offers fee waivers for parties in financial hardship, although the criteria applied are not public.

The ADR framework operated by FINRA has been the object of criticism, arising from[130]

- Retail clients being forced by brokers to waive their rights to go to court before any dispute materialises through standard contractual terms of which they are takers (e.g., when opening a brokerage account).

[128]Filing fees for mediation are $50 for the client and $150 for the firm for claims lower than $25,000 and reach $300 and $500, respectively, for claims over $100,000. A reduction applies for claims first submitted to arbitration. In addition, the parties have to pay the honorarium of the mediator, which is not standard but depends on the mediator.
[129]FINRA, "FINRA Dispute Resolution: Party's Reference Guide to Simplified Cases" (12 March 2014).
[130]See, for instance, the following news stories: *Bloomberg Businessweek*, "Investors, Meet Your Arbitrators" (28 April 2014); Investmentnews.com, "FINRA Arbitration a Wholesale Abdication of Legal Rights" (17 January 2012); *New York Times*, "Schwab Case Casts Spotlight on Securities Arbitration and Its Flaws" (4 September 2013); and *New York Times*, "A Rise in Requests from Brokers to Wipe the Slate Clean" (10 June 2013).

- Lack of transparency and potential conflicts of interest regarding the selection and removal of individuals from the list of eligible arbitrators.
- Lack of transparency and potential conflicts of interest regarding the outcome of arbitration for consumers. FINRA discloses that consumers received redress in 42% of cases in 2013 but provides no comparison against the amount claimed and no breakdown per settled and nonsettled cases.
- Permitting the expungement of cases—that is, making the records of the case unavailable and only publishing the award, depriving investors of information regarding past behaviour by brokers. Moreover, arbitration awards are not explained unless the parties pay an additional fee.
- The complexity of the procedure, derived from its adversarial nature, and the high costs that come with it. In particular, the process is hardly economical for small claims and is subject to a high degree of procedural uncertainty.
- Insufficient incentive for firms to agree to a reasonable settlement, which cannot be proposed by the mediator. Such incentives could include publicity of the failure by firms to follow the settlement recommended by an independent third party.[131]
- Lack of independent oversight of the process by a public body, such as the securities supervisor (SEC) or another governmental agency.

Annex 2 provides a comparison between the ADR schemes operated by FINRA in the United States and the FOS in the United Kingdom. Both schemes are benchmarked against best practice principles in alternative dispute resolution. These jurisdictions are compared by reason of both their adjudication traditions being based on adversarial, rather than inquisitorial, principles.

Case Study 4: ADR in the Asia-Pacific Region

ADR frameworks are also growing in importance in the Asia-Pacific region. We reviewed the schemes operating in Singapore, Hong Kong, and Australia.

- In **Singapore**, the Financial Industry Disputes Resolution Centre (FIDReC) has operated since 2005 for claims between consumers and financial institutions. The scheme is open for claims of up to S$100,000 (≈ €57,000, or US$80,000) in insurance and

[131]Fiuinvestorclinic, "Ombudsman: An Attractive Alternative to FINRA Mediation?" (15 December 2011): http://fiuinvestorclinic.wordpress.com/2011/12/15/ombudsman-an-attractive-alternative-to-finra-mediation.

S$50,000 (≈ €29,000, or US$40,000) in other disputes. The scheme offers mediation as a first step, free of charge for the consumer. If no agreement is reached in mediation, the consumer may choose to pursue the case through arbitration by paying a nominal fee of S$50 per claim (≈ €29, or US$40).[132]

External legal representation is not allowed, but in-house legal counsel is permitted. Arbitration involves a hearing; the decision is based on law but tempered by considerations of fairness and equity. This decision is binding on the financial institution but not on the consumer. In 2012–2013, FIDReC resolved 607 complaints (50% in three months and 93% in nine months) and handled 2,273 inquiries. The process and outcomes are kept confidential. The scheme is financed by a levy on subscribing firms (470 in 2013).[133]

- In **Hong Kong**, the Financial Dispute Resolution Centre (FDRC) has operated an ADR scheme since November 2011. The scheme is open to complaints by individual consumers against any financial institution authorised by the Hong Kong Monetary Authority (HKMA) or the Hong Kong Securities and Futures Commission (SFC). The claim cannot exceed HK$500,000 (≈ €47,000, or US$65,000). Claimants must first complain to the relevant financial institution; they can only access the scheme in case of a negative response or no response within 60 days. As a first step, the scheme offers mediation and, only if no agreement is reached, arbitration. No hearings are held in arbitration, which is decided on a "documents-only" basis.

  Legal representation, including in-house counsel, is not permitted. The FDRC keeps a list of mediators and arbitrators and only uses its own staff for mediation in small claims. Fees are payable by both parties and can exceed €1,000 for arbitration.[134] The duration of mediation is limited to four hours (in one session); for arbitration, a decision has to be issued within one month after submission of the last piece of evidence. Recently launched, the FDRC received 16 applications for mediation and 1,054 inquiries from June 2012 to December 2012.[135]

[132]In addition, the firm will pay S$500 per claim (approximately €290, or US$400).
[133]More information is available at www.fidrec.com.sg and in FIDReC, "Resolving Your Financial Disputes: Annual Report 2012–2013" (2014); FIDReC, Terms of Reference (7 December 2013).
[134]When submitting a claim, the consumer pays HK$200 (≈ US$26, or €20). When the case goes to mediation, the consumer pays HK$1,000–HK$2,000 (≈ US$129–US$258, or €93–€186) and the firm HK$5,000–HK$10,000 (≈ US$645–US$1,290, or €465–€930). If the matter goes to arbitration, the consumer pays HK$5,000–HK$12,500 (≈ US$645–US$1,612, or €465–€1,163) and the firm HK$12,500–HK$20,000 (≈ US$1,612–US$2,580, or €1,163–€1,860). For arbitration, the smaller the amount claimed, the higher the fee for the firm.
[135]More information is available at www.fdrc.org.hk and in FDRC, Mediation and Arbitration Rules (2014), and FDRC, "2012 Annual Report" (2012).

- In **Australia**, the FOS is open to claims from individual consumers and small businesses in relation to most financial services or products. The process follows a four-step approach:

    1. Initially, the dispute is referred to the financial service provider, who has 45 days to respond to the consumer outside the scheme.

    2. If the consumer is not satisfied with this response, the case proceeds to mediation and initial assessment.

    3. If mediation is not successful, the FOS will carry out a detailed assessment and recommend a solution to the parties.

    4. If the parties do not agree to the recommendation, the case proceeds to arbitration and final decision. Arbitration is carried out by an ombudsman on its own or together with a consumer representative and industry representative. Their decision is based on law, motivated and binding on the financial service provider but not the claimant. It may award up to A$280,000 (≈ €190,000, or US$260,000) in remedies and no more than A$12,000 for consequential loss, nonfinancial loss, and costs incurred by the claimant in pursuing the matter. Punitive damages may not be awarded.

    In 2012–2013, FOS closed 33,773 disputes, 70% of which were settled. Only 9% of cases required a final decision in arbitration; 55% of cases were resolved within two months and 70% in more than four months. The scheme is free of charge for claimants. Annual expenditure by the FOS was A$44.6 million in 2012–2013—equivalent to A$1,320 per dispute closed. The FOS reports back to the Australian regulator, including on matters of serious misconduct and systemic issues.[136]

[136]More information is available at www.fos.org.au and in FOS, "2013 Independent Review of the Australian Financial Ombudsman Service", Cameron Ralph Navigator (2014); FOS, "2012–2013 Annual Review"; and FOS, Terms of Reference (2010, amended 1 January 2014).

ANNEXES

Annex 1. The Principles in Directive 2013/11/EU on Consumer ADR vs. the Special-Purpose ADR Schemes in Spain and the United Kingdom

Principles in Directive	Spain (for households holding hybrid instruments and subordinated debt)	United Kingdom (for small businesses holding interest rate hedging products)
Accessibility		
	-Third parties (called "independent experts") were able to refuse to submit the dispute to arbitration only in a limited number of instances. -The ADR process was free of charge for clients, irrespective of outcome.	-Third parties (called "independent reviewers") were able to refuse access to the ADR process only to sophisticated investors. -The ADR process was free of charge for clients, irrespective of outcome.
Expertise		
	-The resolution authority approved the appointment of independent experts and assessed their level of skills and competence. -Arbitrators were high-ranking legal professionals in the public sector who were trained in the field of the controversy.	-The supervisor approved the appointment of independent reviewers, assessing their skills and expertise (in relation to the instruments and the clients).
Independence		
	-Independent experts were selected by the banking entities (parties to the dispute) but were subject to approval by the resolution authority. -Arbitrators were civil servants, ascribed to publicly financed and preexisting ADR entity ("Junta Arbitral Nacional" and regional equivalents). -Monitoring entity was composed of public authorities and consumer representatives.	-Independent reviewers were selected by the banking entities (parties to the dispute) but were subject to approval by the supervisor. -The supervisor monitored conflicts of interest and, where needed, required the appointment of a second expert. -Banks agreed with supervisor that the opinion of the independent reviewer was to prevail over that of the bank in case of controversy.

Principles in Directive	Spain (for households holding hybrid instruments and subordinated debt)	United Kingdom (for small businesses holding interest rate hedging products)
Transparency		
	-The criteria for the assessment of the merits of each case and the maximum compensation were published. -Individual communications were sent to concerned clients regarding the ADR process. -The summary statistics on the outcomes for parties and the application of criteria were not published as of 20 June 2014. -There is insufficient transparency for the general public (monitoring reports are not publicly available).	-The criteria for the assessment of the eligibility of the clients to access the ADR process, assessment of the merits of the case, and to determine redress were published. -Individual communications were sent to the concerned clients regarding the ADR process. -The summary statistics on outcomes and application of criteria were published and frequently updated during the process.
Effectiveness		
	-The total time to complete full process was not available as of 20 June 2014. -The average time to resolve a dispute was not available as of 20 June 2014. -The average cost per dispute was not available as of 20 June 2014.	-Regarding the total time to complete the full process, the review started in May 2013 and in June 2014, only 976 cases were still being assessed (3.3% of cases). -The average time to resolve a dispute was not available as of 31 May 2014. -The average cost per dispute was not available as of 31 May 2014.
Fairness		
	-Parties had the opportunity to provide documents and information to independent experts and (in case of the discovery of new, relevant information) to arbitrators. -Clients were not given the opportunity to raise their arguments before an arbitrator if the opinion of the independent expert was negative.	-Client testimony was established as a critical part of evidence in assessing each case. -Clients who were assessed as sophisticated could complain to their bank. -Clients retain the possibility of launching court proceedings or referring their complaint to the FOS (subject to ordinary restrictions on access to these instances).

Principles in Directive	Spain (for households holding hybrid instruments and subordinated debt)	United Kingdom (for small businesses holding interest rate hedging products)
Liberty		
	-Clients were free to request an assessment of their case by an independent expert. -Clients were free to request arbitrage upon a positive assessment of the independent expert. -Clients were free to go to court upon a negative assessment of the independent expert. -Clients renounced the right to take the case to court upon requesting arbitrage and knowing the likely recoverable amount. -The decision by arbitrator was binding on both parties. -The arbitrators followed the (positive) decision of the independent expert in over 90% of cases (99% of cases, according to projections on 25 April 2014).	-Clients were free to opt into the ADR process. -Clients were free to accept the redress outcome proposed at the end of the ADR process. -Clients were not asked to renounce their rights to launch proceedings before a court of justice or raise their dispute before the FOS (subject to the restrictions ordinarily applicable to access each of these instances).
Legality		
	-The arbitrage was in law, not in equity. -Limitation of object of the dispute and criteria to assess the merits of the case plus maximum amount recoverable and calculation methodology.	-The arbitrage was in law, not in equity. -Limitation of the object of the dispute and criteria to assess the merits of the case plus guidance on determining "fair and reasonable" redress.

Source: Based on data from FROB, KPMG, CNMV, Comisión de Seguimiento, and FCA.

Annex 2. ADR Schemes Operated by FINRA vs. by FOS

Principles of Best Practice in ADR	FINRA ADR (United States)	FOS ADR (United Kingdom)
Accessibility		
	-Process applies to claims against entities registered with FINRA (brokerage firms). -The costs of arbitration may exceed several thousands of dollars, without counting costs for legal assistance. -The process is uneconomical for small claims.	-Process applies to claims from consumers against any firm supervised by the FCA. -The jurisdiction is compulsory for the service provider but not for the consumer. -The process is free of charge for consumers (the costs of the FOS are financed by firms through levies and case fees).
Expertise		
	-FINRA provides basic and subject-specific training modules to arbitrators.	-FOS provides a formal training program for its staff members. -FCA provides information to the FOS on relevant regulatory matters.
Independence		
	-Arbitrators are screened by FINRA for conflicts of interest and consumers may choose a panel with no ties to the industry. -However, FINRA is financed by industry and there have been complaints regarding conflicts of interest and selection of arbitrators.	-FOS is an independent body established by law. -The ADR scheme is financed by firms through compulsory levies, established by the FCA for all supervised firms, and case fees.
Transparency		
	-Information is available for consumers, but the process is difficult to understand without expert legal advice. -There is a lack of transparency regarding decisions (expungement of records is permitted in some instances).	-FOS publishes clear guidance for consumer to understand the ADR process. -FOS publishes aggregate data on complaints. -FOS may publicly name specific firms for misbehaviour.
Effectiveness		
	-Average duration is 12 months (no hearings) or 16 months (with hearings). -The complexity of the procedure makes assistance by a legal expert necessary in practice (despite there being no formal obligation). -Procedures involve discovery, subpoenas, examination, cross-examination, etc.	-In 2013, the duration of the procedures was less than 3 months in 43% of cases, less than 6 months in 73%, less than 9 months in 84% of cases, and less than 12 months in 89% of cases (for all cases except those relating to payment protection insurance).

Principles of Best Practice in ADR	FINRA ADR (United States)	FOS ADR (United Kingdom)
Fairness		
	-Parties have the opportunity to participate in hearings. -Parties are informed of effects of procedure.	-Both parties have the opportunity to present their arguments, although formal hearings are rarely held. -Parties are informed of the effects of procedure.
Liberty		
	-Consumers are frequently forced into waiving access to courts before any dispute materialises.	-Consumers are not bound by the FOS decision and can bring cases to the courts.
Legality		
	-Arbitrators decide in law. -Awards are not explained unless an additional fee is paid.	-Decisions are based on what is considered "fair and reasonable" (taking into account law and equity). -Decisions are explained by the FOS staff.

Source: Based on data from FINRA and FOS.

Annex 3. Basic Criteria for the Assessment of the Merits of the Case in Special-Purpose ADR Scheme for Hybrid Instruments and Subordinated Debt in Spain

- *Relative to the capacity to contract:* If the investor was a minor or a person with a mental disability and entered into the contract without the intervention of a legal representative.

- *Relative to the contractual documentation:* If there was no contract, if relevant documentation was missing, or if there were significant inaccuracies in the contract.

- *Relative to the information provided to the client:*

  - If there was missing information (or if incorrect information was provided) about the product features and risks, before entering the contract—for instance, if (1) the level of risk was wrongly stated as safe or conservative, (2) the product was wrongly classified as noncomplex, or (3) there were errors or omissions regarding the term of the investment, the level of liquidity risk, or the degree of subordination.

- If additional information on the product was provided that was incorrect, contradictory to, or inconsistent with the information contained in the contractual documentation.

- *Relative to the collection of information about the client by the entity:*
  - If there was no procedure in place to collect the data relevant to establishing the profile of the client (to apply the client categorisation under MiFID).
  - If the procedure used to establish *suitability* was manifestly incorrect, taking into consideration such elements as (1) the answers provided by the client or (2) a lack of previous investment experience by the client, cumulative with a lack of work experience in the financial sector or knowledge of products with a similar or higher level of risk.
  - If the procedure to establish *appropriateness* was manifestly incorrect, taking into consideration such elements as (1) the weight of the investment in the wealth of the client, excluding its main dwelling, or (2) accreditation by the client or recognition by the entity that it had recommended the product without performing an appropriateness test or that it provided incorrect verbal information.

- *Other circumstances of the client concurring at the moment of sale*, such as the weight of the investment in the wealth of the client and lack of other relevant sources of income.

The guidelines also establish the order of preference to process ADR claims: (1) age, from older to younger clients; (2) household income, from lower to higher; (3) weight of the investment in the wealth of the household, excluding its main dwelling; and (4) principal invested, from bigger to smaller.

Source: FROB, Fondo de Reestructuración Bancaria Ordenada, "Publicidad de los criterios básicos determinados por la Comisión de Seguimiento de Instrumentos Híbridos de Capital y Deuda Subordinada", press release (17 April 2013).

Annex 4. Basic Criteria for the Assessment of Non-Compliance in Special-Purpose ADR Scheme for Interest Rate Hedging Products in the United Kingdom[137]

The banks (and independent reviewers) will need to assess whether each sale complied with the regulatory requirements (our principles, rules and guidance) at the time of sale. We have had rules in place governing the sale of IRHPs to "non-sophisticated" customers for the whole period covered by this review (for example, COB 2.1.3 R, COB 5.2.5 R, COB 5.4.3 R to COB 5.4.6 E and COB 5 Annex 1 for sales up to 31 October 2007, and COBS 2.1.1 R, COBS 2.2.1 R, COBS 4.2.1 R, COBS 14.3.2 R for sales from 1 November 2007. In addition, Principles 6 and 7 applied throughout the period). Based on these rules, we would, for example, expect that for sales within the review:

- The bank provided the customer with appropriate, comprehensible and fair, clear and not misleading information on the features, benefits and risks associated with the IRHP in good time before the sale.
- If the IRHP exceeds the term or value of any lending arrangements, the potential consequences were disclosed to the customer in a comprehensible and fair, clear, and not misleading way.
- In relation to an advised sale: (a) The bank has obtained sufficient personal and financial information about the customer, including the customer's investment objectives, level of education, profession or former profession and relevant past experience of IRHPs. (b) The bank has taken reasonable steps to ensure that the personal recommendation is suitable for the customer.

[…] Our view is that, for the disclosure of break costs to comply with our regulatory requirements, the bank should be able to demonstrate that:

- In good time before the sale, the bank provided the customer with an appropriate, comprehensible and fair, clear and not misleading disclosure of any potential break costs.

To determine whether a sale complied with our regulatory requirements, the banks will need to take account of the individual circumstances of the customer and the circumstances of the sale to determine whether it is reasonable to conclude that the customer could have

[137]FSA, "Interest Rate Hedging Products: Pilot Findings" (March 2013).

understood the features and risks of the product. This will be a case-by-case assessment which may involve a consideration of:

- the customer's knowledge and understanding of these types of products generally;
- the customer's interaction during the sales process;
- the complexity of the product; and
- the quality and nature of the information provided during the sales process and when and how it was provided.

Source: FSA, "Interest Rate Hedging Products: Pilot Findings" (March 2013).

Annex 5. Internal Handling of Complaints and ADR in Key EU Financial Services Legislation Relevant to the Investment Sector

Legislative Instrument (and Concerned Intermediaries)	Internal Handling of Complaints	Alternative Dispute Resolution
Markets in financial instruments directive (investment firms, such as brokers, advisers, and asset managers providing discretionary services)	Maintain effective and transparent procedures for the reasonable and prompt handling of complaints from retail clients or potential retail clients, keeping records (Article 10, Directive 2006/73/EC)[a]	Member states shall ensure access to ADR schemes, and firms must adhere to one or more of such schemes (Article 75, Directive 2014/65/EU, MiFID II)
Insurance mediation directive (insurance intermediaries)	Procedures that allow customers and interested parties (associations) to register complaints (Article 11, IMD II proposal, Article 10, Directive 2002/92/EC)	Member states shall ensure access to ADR schemes, and firms must adhere to one or more of such schemes (Article 13, IMD II proposal)
UCITS[b] directive (management and investment companies)	Maintain procedures to handle complaints from investors, free of charge, including when operating cross-border, keeping records (Article 6, Directive 2010/43/EC)	Member states shall ensure existence of ADR schemes (Article 100, Directive 2009/65/EC)

[a]Implementing Article 13.2, Directive 2004/39/EC (MiFID I) equivalent to Article 16, Directive 2014/65/EU (MiFID II).

[b]Undertakings for Collective Investment in Transferable Securities Directives.

Annex 6. Powers of the Government and Supervisory Authority of the United Kingdom to Establish and Operate Special-Purpose ADR Schemes

Section 404: Schemes for reviewing past business.

1. Subsection (2) applies if the Treasury are satisfied that there is evidence suggesting:

a. that there has been a widespread or regular failure on the part of authorised persons to comply with rules relating to a particular kind of activity; and

b. that, as a result, private persons have suffered (or will suffer) loss in respect of which authorised persons are (or will be) liable to make payments ("compensation payments").

2. The Treasury may by order ("a scheme order") authorise the Financial Services Authority to establish and operate a scheme for:

a. determining the nature and extent of the failure;

b. establishing the liability of authorised persons to make compensation payments; and

c. determining the amounts payable by way of compensation payments.

Extract from the Financial Services and Markets Act of 2000.

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