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RETAIL INVESTMENT STRATEGY: IMPROVING RETAIL INVESTOR'S ACCESS TO EU-27 FINANCIAL MARKETS

AMAFI POSITION PAPER

The sanitary crisis, Brexit and the conflict in Ukraine have underlined the necessity for the Union to develop and strengthen its open strategic autonomy globally and especially in the financial sector area.

The Covid-19 health crisis has severely impacted the EU-27 economy and caused debt to surge, increasing the need for the EU to bolster its market-based financing capacity, not just to support the economic recovery but also to regain some autonomy in sectors the crisis has led to be identified as strategically important.

In this context, the relaunching and deepening of the CMU project has a central role to play to increase the competitiveness of EU actors and the attractiveness of EU financial markets in a post-Brexit ecosystem[1].

The main objectives should be to enable EU markets to further contribute (i) to the economic recovery at national and European levels and (ii) to the financing challenges the Union is facing, in relation to the mitigation of climate change, the ageing of the population and the development of EU champions in strategic fields such as digital and sustainable finance.

As highlighted in the 2020 Capital Markets Union Action Plan, the Retail Investment Strategy (RIS) is instrumental to strengthen retail investors' confidence in capital markets so they can further contribute to the Union's core financing challenges. In a competitive financial environment, retail investors should be in a capacity to make profitable investments – especially given the inflationary context – while benefiting from a sufficiently high level of investor protection.

With these objectives in mind, based on AMAFI's previous note on the RIS (*AMAFI / 21-48*), this paper takes stock of ESMA's April 2022 Technical Advice (TA) on certain aspects relating to retail investor protection[2], of the ESAs May 2022 TA on PRIIPs KID[3] as well as the EC targeted consultation to enhance the suitability and appropriateness assessments[4] and aims to highlight the Association's core priorities in order to contribute to the EC's current reflexion[5] that will lead to the publication of the RIS in the first half of 2023.

This paper is divided in three parts articulated around (i) the understandability of the information delivered to investors, (ii) the distribution of financial instruments and (iii) the impact of digital innovation on information disclosure.

[1] For further details please see AMAFI-CEPS report on Completing Capital Markets Union.
[2] https://www.esma.europa.eu/sites/default/files/library/esma35-42-1227_final_report_on_technical_advice_on_ec_retail_investments_strategy.pdf
[3] https://www.esma.europa.eu/press-news/esma-news/esas-recommend-changes-make-priips-key-information-document-more-consumer
[4] https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/2022-suitability-appropriateness-assessments-consultation-document_en.pdf
[5] The EC published in July its study on Disclosure, inducements, and suitability rules for retail investors.

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I. Ensuring the understandability of information delivered to investors

a. Reducing information overload

We welcome the fact that ESMA acknowledges the issue of information overload in its TA on retail investor protection.

Based on our members' experience, superfluous information still exists and should be further reduced, for instance with regards to best execution reports[6] and information on costs and charges.

On this last issue, to further simplify the existing regime without damaging retail investors' protection, we would support the use of tariff grids for simple financial instruments such as bonds and shares[7]. Besides, the requirement to provide an illustration of the impact of aggregated costs on return should be removed, experience showing that this concept is not understood by clients. Finally, ex ante information should not be required on cost and charges for sell orders.

b. Providing key information

ESMA proposes in its TA on retail investor protection to use a dashboard with key information that would be prominently disclosed in all products and services marketing communications and would be integrated in existing regulatory disclosure.

While we believe that it could allow easier comparisons between products and services, this would not contribute to reducing the information overload. Actually, the proposed key information look like a duplication of information which already exists in the ex-ante MiFID disclosure documents and/or the PRIIPs' KID.

As a way forward, we would recommend the use of consumer testing aiming to define the content and format of key information to be provided to clients.

c. Considering a targeted approach to the PRIIPs Regulation

We believe it is critical to consider targeted adjustments with regards to the approach for autocallable products and the methodology used to present cost and performance scenarios for such products.

Considering the ESAs TA on PRIIPs, we believe the use of a dashboard that would highlight or summarize the essential information on the PRIIP as a further layer of information may not serve the overarching principle of clarity of information. As such, consumer testing shall be thorough and the dialogue with all the components of the financial industry is of prime importance.

With regards to costs and charges disclosures between MiFID II and PRIIPs, we welcome the proposed alignment as proposed in the TA. In addition, to ensure more consistency between MIFID II and PRIIPs, we would call for the methodology used to present costs in PRIIPs KIDs to be changed to a Total Expense Ratio (TER) approach that would enable the aggregation of service costs with product costs[8].

Finally, looking at the scope of the Regulation, although we agree that OTC derivatives intended for mass distribution should fall within the scope of the PRIIPs Regulation, those contracted for corporate clients should not because (i) they are not distributed to retail investors, (ii) there is no "investment opportunities" but to hedge risks (interest rate or foreign exchange), (iii) there is no repayable amount to the retail investor as stated in the definition of a PRIIP, and (iv) some derivatives exposed solely to an interest rate are similar to fixed-rate or variable-rate deposits, which are outside the scope of PRIIPS.

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[6] AMAFI calls for the deletion of RTSs 27 & 28 in the MiFIR review and welcomes the proposal, in the draft report by Rapporteur Hübner, to review articles 27(3) and 27(6) of MiFID accordingly.

[7] By doing so, investment firms would not be required to repeatedly, before each trade, provide the same transaction costs in % to clients.

[8] The current PRIIPs methodology is based on the Reduction in Yield (RiY) which is a concept that is not well understood by retail investors.

II. The distribution of financial instruments

a. Preserving the value of the inducement framework

Generally speaking, we have serious doubt that an outright ban of inducement would be the most efficient way to solve conflicts of interest that could be encountered by retail clients.

As evidenced in the November 2021 KPMG survey[9] on commission-based remuneration vs. fee-based remuneration, it would inevitably to contribute to an “advice gap” or a “service gap” for the important share of the retail segment where firms rely on inducements to maintain/enhance the quality of the relevant service to the clients.

This is all the more important as a decrease of investment advice resulting from a ban on inducement would probably be detrimental to the distribution of ESG products, and/or to those providing some form of capital protection, due to the complexity of their features which makes challenging for a retail client to assess, by himself, products that are the most suitable according to its needs.

As such, we would propose a two-step approach to deal with the potential issue of undue costs charged to clients.

First, through an increased and harmonized transparency that would foster comparability. A standardised and enriched inducement disclosure template at EU level may have merits as it would make clearer:

i) On an ex ante basis what quality enhancement the client is likely to benefit from in exchange for the inducements perceived by the distributor ;

ii) On an ex post basis, what quality enhancement the client benefited from during the year fot what level inducements perceived by the distributor ;

Second, through a cost / benefit approach clarifying and strengthening the expectations from both manufacturers and distributors aiming at respectively assessing that (i) the products they manufacture are not unduly costly and (ii) that the products they distribute are not unduly costly.

Such proposal would also have the merit, compared to an inducement ban, to tackle closed architecture models where both manufacturers (potentially not falling under MiFID rules) and distributors belong to the same group and no or little inducements are paid from one to the other.

Finally, another possible way of enhancing practices would be to harmonize the rules (both on inducements and on disclosure of cost and charges) between the different pieces of regulation (primarily securities and insurance rules) that enable to invest in financial instruments.

b. Client assessment (suitability/appropriateness) : ensuring regulatory stability

The proposals suggested by the EC in its February 2022 targeted consultation to enhance the suitability and appropriateness assessments have given rise to a certain number of concerns amongst AMAFI’s members especially given the weaknesses of the current regime have not been demonstrated yet.

First, the proposed new rules would lead to the disappearance of the non-advised business, which would contradict the objective of empowering investors.

[9] French trade associations from the financial sector (AFG, AMAFI, AFPDB, FBF) together with Italian (Assogestioni, ABI, ASSOSIM, FEBAF) and Spanish (Inverco, ABE) associations mandated KPMG to carry out a study[9] that compares the outcome for retail investors under the “inducement model” and the “commissioned-based model”. The findings of the study indicate that the ban of inducements (in the UK and the Netherlands, where advice is provided under a “commission-based model”), has not led to less expensive financial advice. This situation has resulted in limiting investment advice only to clients who can pay for it, meaning that a significant portion of retail clients are excluded from accessing this service. Link. A similar study was led by KPMG on behalf of German trade associations for the German market.

Besides, making portfolios uniform, which is tempting as standardisation might appear more secure in order to comply with regulatory requirements, would not serve the purpose of making sure that investments are fit for the objectives, expectations, and risk sensitivity of investors. This would encourage the development of automated advice on standardised products which would lead to a levelling down of the offered services. This would also create concentration risks and exposure to shocks.

Moreover, this approach would trigger a concentration of clients' savings on a limited range of financial instrument types, with potential consequences on competition and financial innovation, detrimental to clients' interests. It would also raise significant concerns over the liability associated with the preparation/use of a single client profile, and in terms of information update as concerns the preferred asset allocation strategy.

Finally, the proposals made raise overwhelming feasibility challenges.

In light of the above potential issues, a possible way forward may be to create "portfolio advice" or "advice with portfolio approach" as a complement[10] to the current "one shot advice". In line with EC 's proposals, such service, would be based on the entirety of a client's portfolio, and would encompass the provision of a recommended personalized asset allocation strategy that would serve as a basis for the service provided.

Also, considering that the standardisation of products and services is a cause of concern when the defined client investment profiles are to be used as a rigid guideline for investments made under appropriateness and for their monitoring by investment service providers (ISPs), it would be opportune to explore an alternative, lighter solution. This could take the form of a disclosure approach, whereby ISPs would provide clients with an indicative, non-binding information on possible generic portfolio diversification strategies, based on a typology of profiles. In such approach, the provided examples would be purely informative and include no presumption that clients' investments should necessarily remain within the boundaries of the illustrative models.

c. Investors categorisation: reviewing the opt-in procedure

Rather than introducing a new category of investors (semi-professional), we would support reviewing the MiFID II categorization of clients in order to make it easier for retail investors to opt-in to the professional client category by enabling investment services providers to propose this option where relevant.

This would allow more sophisticated clients to be treated as "elective" professional clients, to access certain products which may be suited for their purposes. Such an approach would also have the merit of not disrupting the longstanding *summa divisio* between the different categories of clients that has spread throughout a large amount of different pieces of regulation and is also a corner stone of investment firms' processes and systems.

In case the option to introduce a new category is nevertheless envisaged, it is of utmost importance that this remains voluntary, and that the existing client segmentation would be maintained (*i.e.* this category would be a sub-category of the existing ones).

d. Introducing more proportionality for Product Governance rules

The publication on 26 February 2021 of the MiFID II Quick Fix in the EU Official Journal[11] has brought several welcome enhancements, in particular the alleviation of the product governance requirements for simple corporate bonds with make-whole clauses.

[10] Clients would have the choice between the two types of advice
[11] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021L0338&from=FR%22

However, AMAFI considers that the exclusion is too narrow, given that all ordinary shares and plain vanilla bonds issuances are similarly important for the financing of companies. Other non-packaged/simple/plain vanilla instruments like shares or fixed rate bonds (i.e. all non PRIIPs products) should be exempted as well as (i) these products are not produced to serve additional (retail) investors' needs and objectives or address particular risk profiles, (ii) they are issued to raise capital which is urgently needed and (iii) the added value of product governance requirements for vanilla products is, in principle, very low or nonexistent both in the primary and secondary markets.

Besides, the exemption should not be limited to certain corporate bonds as there is no justifiable reason to favour corporate bonds over bonds issued by banks. The exemption of corporate bonds with make-whole clauses should also be accompanied with the clarification that this category of bonds does not fall under the scope of the PRIIPs regulation.

In any case, if simple bonds and shares were not to be exempted from product governance requirements, at a minimum, it should be made clear that the banks advising the issuer on a new issuance of such financial instruments on the primary market should not be viewed as the manufacturer of such products when it comes to the secondary market.

III. The impact of digital innovation on information disclosure

With digital innovation at the top of the EC´s agenda, we believe that a balanced approach should be taken as it offers both many potential benefits as well as risks for investors, for instance with regards to open finance[12].

The incorporation of the online/digital dimension in every piece of legislation is desirable but it should consist of an interpretation/adaptation of the current regulatory framework through guidelines and not through the creation of new rules.

a. Aligning PRIIPs Regulation and MiFID II digital disclosure requirements

Whilst, through the MiFID II Quick Fix, the provision of information (*e.g.*, suitability report and ex-ante cost information) via electronic means has become the option by default, it is not the case for the PRIIPs KID, where the default option is still paper-based information (except if requested differently by the investor). This creates difficulties in practice, particularly as it has to be proved in case of "non face-to-face contact" that the choice for receiving the PRIIPs KID (between paper-based and digital) is given to the investor.

Therefore, we would call for the PRIIPs Regulation to be aligned with MiFID II in this respect.

b. Avoiding a too prescriptive approach for digital disclosure

Layering techniques[13] are already used and firms shall not be forced to use such techniques at a precise point in time. Moreover, the way of interacting with clients is part of the business model, not all clients have the same needs therefore firms should be able to choose the communication means based on the best knowledge of their customers.

[12] With securities transactions in particular, it is not as simple as creating an API and then third-party service providers are able to offer suitable investment products. The distribution of securities requires knowledge of the investment profile and the risk appetite of investors as well as knowledge of the entire range of securities products. The range of products is broader than simply providing a payment service. Opening the API will not address the complexity of securities, their investment, or distribution.

[13] There are various approaches and design concepts that firms can use in websites, email, social media, advertisements and marketing material, mobile apps, and other electronic media and that through these channels firms can offer the possibility to clients to view information in narrative, tabular or even audio/video format.

With regards to versioning[14], the display of all versions of the MiFID digital disclosures provided to clients is far reaching and does not contribute to reduce the overload of information. A reasonable balance should be struck between updating information on an ongoing basis and the possibility for clients to revisit old information.

Therefore, we consider that the contemplated ESMA Guidelines on these digital techniques should not be too prescriptive.

About AMAFI
Association française des marchés financiers (AMAFI) *is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI's members operate for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives, including commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions.*

[14] Firms' requirement to retain a copy of all versions of the MiFID digital disclosures provided to clients and should use technology, where possible, to maintain records of when each version was available to allow clients and potential clients to be able to prove which version of the disclosure they relied on.