Securities and Markets Stakeholder Group

Date: 8 August 2014
ESMA/2014/SMSG/035

ADVICE TO ESMA

Investor Protection Aspects of the Consultation Paper on MiFID II and MiFIR

I. Executive summary

The MiFID II and MiFIR constitute a real improvement in the protection of investors, with significant changes, as well as new powers granted to national competent authorities (NCAs) and to ESMA.

As part of its preparations for advising the European Commission on how to implement this legislation, ESMA has provided only limited time (two months and one week) for the public consultation. Therefore, the SMSG decided to only provide advice on selected key issues of importance for retail investor protection while raising also some more general concerns. In general, the SMSG would like to stress that there is a need to think about the combined effect of all the potential changes, rather than just looking at each proposal in isolation. The SMSG is also concerned by the fact that the Technical Advice in some parts is written in a very detailed and technical language which makes it challenging for both investors as well as professionals to assess what the final law would really entail. The SMSG thus calls for more clarity.

On the issue of enforcement, the SMSG would like to remind that strong enforcement of the rules is just as important as having the best rules. The financial crisis was due at least, as much, if not even more, to weak enforcement of existing rules as to insufficient rules per se. The SMSG considers that the power to remove physical persons from the industry is an essential power in order to protect investors from mis-selling and other abuses and should be strongly enforced by NCAs. The SMSG also calls on ESMA to, at a later stage, undertake a mapping exercise on national civil liability regimes in relation to the new MiFID-regime.

On the issue of underwriting and placing, conflicts of interest and provision of information to clients, the SMSG notes with great satisfaction that the issue of self-placement, which it raised with ESMA in 2012 and 2013 with a view to the case of the Participaciones preferentes *in Spain, is being singled out in the Consultation Paper. The SMSG advises an even stronger wording of the Technical Advice and also that ESMA use the approach developed in Spain by the CNMV as a model and also considers developing a specific Guideline on this issue. In the meantime, the SMSG supports and invites ESMA to exercise strongly its powers in terms of supervisory convergence, especially in relation with the Asset Quality Review (AQR) of the EBA and the stress test of the ECB that will be completed in November 2014.*

The SMSG is very concerned with the risk of a reduction of the "open architecture" model in Continental Europe. Therefore, in general, the SMSG requests that ESMA adopt an approach of the regime of inducements for non-independent financial advisers aimed at minimising the risk of negative impact on the current "open architecture" system which provides benefits to retail investors. Open architecture benefits investors as, to take just one exemple, independent manufacturers of investment products, which do not have their own distribution channel, have typically, and also logically, shown better performance, as they cannot rely on a "captive" group of customers but must prove their competence or disappear. The

SMSG also wants to underline that the political compromise at Level 1 did not imply a de facto ban on inducements in the context of non-independent advice. The SMSG understands that this is also the view of ESMA, but this is not so clear from the Technical Advice. Therefore, the SMSG requests that the definition of instances when the "quality enhancement" test is not met in Points 10-11 (p. 124) be redrafted in order to make it easier to understand for those concerned and also ensure that the model of "open architecture" is preserved.

Closely linked to this issue, the SMSG notes the risk of a shrinkage of the availability of advice for retail investors. The experience in the UK gained through the Retail Distribution Review (RDR), although still at an early stage and evolving advises cautions. It appears particularly that middle income savers now have great difficulty in finding decent advice on their savings needs, even as their need for guidance increases the more this could lead to a two-tier system where an increasing proportion of advice is focused on higher income target groups.

On the same issue of avoiding unintended adverse consequences, the SMSG considers a major issue that ESMA labels investment research as an inducement as this will lead to a de facto ban. This could have adverse severe consequences on research on SMEs which MiFID II aims at the same time rightfully to support. We strongly advise ESMA to reconsider their stance by deleting the paragraph relating to investment research.

The SMSG is also concerned that due to various own initiatives from national competent authorities (NCAs) in order to protect investors, a fragmentation of the single market might occur. This fragmentation already existed under the MiFID I regime, but it is made much more problematic now by the significant extension of the scope of MiFID II and MiFIR as well as by the granting of new powers to regulators.

On the issue of disclosure of costs, the SMSG supports the approach of the Consultation paper but also calls for the adoption of an easy to read summary table of costs and performance to be provided annually to the investor. The SMSG has included in its advice a model for such a table.

On the issue of suitability and costs, the SMSG believes that the assessment to be made whether there is an alternative instrument with lower costs is crucial and congratulates ESMA for including this requirement in its draft Technical Advice. The SMSG strongly advises that the assessment be provided in the suitability report regardless of the lower cost alternative instruments being part of the investment firm's offering or not. However, some members of the SMSG believe that these requirements are simply contradicting the suitability assessment which is meant to provide investors with the best possible and best suitable advice. The SMSG suggests a consensual alternative drafting of the advice on this issue.

As to the new powers, both the NCAs as well as ESMA can now exercise product intervention powers. With this in view, the relevant criteria and factors to be taken into account by competent authorities in determining when there is a significant investor protection concern would need to be simplified and clarified. Also, the SMSG notes that the draft Technical Advice tends to describe the NCA's intervention powers as a complementing measure whereas it is a mere subsidiary instrument. However, some members of the SMSG are of a different view and consider that the deterrent dynamic of these powers is potentially significant and to have this useful effect, the product intervention power needs to be characterized as a complementary and operational (albeit certainly radical in nature) power to be activated when necessary

Finally, the SMSG wants to stress that the combined effects of different regulations need to be considered to ensure a clear alignment and consistency with relevant product directives as well as with PRIIPs and IMD 2. Therefore the SMSG calls for those legislations to be aligned as this would be in the best interests of investors.

II. Explanatory remarks

1. The legislative texts of the new Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR), introduced by the European Commission in October 2011, were approved by the European Parliament on 15 April 2014 and by the European Council on 13 May 2014. They were published in the Official Journal of the European Union on June 12 2004 as the a directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (MiFID II) and a Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments. The new MiFID II and MiFIR rules will have to be implemented in the Member States by 3 July 2016 and they will begin to apply on 3 January 2017, subject to limited transitional provisions.

2. The European Securities and Markets Authority (ESMA) received a formal request (mandate) from the European Commission (Commission) on 23 April 2014 to provide technical advice to assist the Commission on the drafting of the possible content of the delegated acts required by several provisions of MiFID II and MiFIR. ESMA is required to provide technical advice by no later than six months after the entry into force of MiFID II and MiFIR, ie by 3 January 2015.

3. On May 22, 2014 ESMA published a consultation paper relating to technical advice to be proposed by ESMA to assist the Commission on the possible content of the delegated acts required by several provisions of MiFID II and MiFIR. The requested responses must reach ESMA by 1 August 2014, a deadline which is very short when considering the magnitude and complexity involved. Given this very short period the SMSG working group on retail investor protection decided to focus its advice on selected key issues, while covering also some other points but in a more extensive manner. The compliance function will be dealt with separately.

4. In general, the SMSG notes that ESMA proposes to include into its advice principles set out in previous Guidelines (ex: compliance function, Point 2.3). The SMSG approves this evolutionary approach.

5. As mentioned above, due to the short deadline, the SMSG decided to focus on key selected issues which are listed below:

    2.6. Recording of telephone conversations and electronic communications

    2.7 Product governance

    2.9. Conflicts of interest

    2.10. Underwriting and placing – conflicts of interest and provision of information to clients

    2.14. Information to clients on costs and charges

    2.15. The legitimacy of inducements to be paid to/by a third person

    2.17. Suitability

    2.24. Product intervention

6. Before turning to these key selected issues, the SMSG would also like to point to five high level issues, which appear also in the key selected issues. In general, the SMSG would like to stress that there is a need to think about the combined effect of all the potential changes, rather than just look at each one in isolation.

1. Fragmentation of the market

7. The SMSG is concerned that due to various own initiatives from national competent authorities (NCAs) in order to protect investors, a fragmentation of the single market might occur. This situation already exists under the current MiFID I regime, but it is made much more problematic now by the significant extension of the scope of MiFID II and MiFIR as well as by the granting of new powers to regulators. Therefore, the SMSG calls on ESMA to monitor closely such developments trying to promote consistency of approach as much as possible.

2. Enforcement

8. The SMSG would also like to call attention to the fact that strong enforcement of the rules is just as important as having the best rules. The quality of protection of retail investors should be raised not just by rules but also by a level of enforcement and penalty which discourages repetition of the behaviour and is not just a "rap on the knuckles".

9. The SMSG is of the view that the power to remove physical persons from the industry is an essential power in order to protect investors from mis-selling and other abuses and should be strongly enforced by NCAs. The SMSG would welcome, after the implementation of the MiFID II directive, a peer review exercise on the use of enforcement powers by NCAs with a special emphasizes on the use of this removal power by NCAs.

10. The SMSG would also like to mention that in many Member States private enforcement is even more important than fines and other measures by NCAs. In particular this is true for all duties for investment firms advising clients. The SMSG notes that in its 2010 Public Consultation, the Commission considered whether to introduce a principle of civil liability of investment services providers.[1] However, this point was not followed up on by the Commission in its proposal. Therefore, the SMSG thinks that it would be helpful to know which role private enforcement (esp. of the suitability doctrine) plays in the Member States. ESMA has already examined and compared the national liability regimes in relation to the Prospectus Directive (ESMA/2013/619). The SMSG suggests that ESMA do the same for the new MiFID-regime. This would be an important workstream for the period after the implementation of level 2-measures of MiFID II/MiFIR.

3. "Open architecture"

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1 Public Consultation, Review of the Markets in Financial Instruments Directive (MiFID), 8 December 2010, page 63 Point *7.2.6. Liability of firms providing services* « While investment firms are subject to possible administrative sanctions by the competent authorities if they infringe MiFID rules, the directive does not deal with the liability of firms towards clients in cases where infringement of MiFID rules causes damage. Thus, the conditions for such civil liability vary according to Member States' civil legal orders and may sometimes be difficult to establish. The Commission services regularly receive complaints, especially from retail investors, claiming that firms have violated conduct of business obligations. Introducing a principle of civil liability of investment services providers would be essential for ensuring an equal level of investor protection in the EU. Such a principle, could be included in the framework directive and would enable clients to claim damages against investment firms infringing MiFID rules, particularly in areas concerning the relationship between firms and clients and where specific obligations towards the client are foreseen. The following areas could be covered: information requirements, suitability and appropriateness test, reporting requirements, best execution and client order handling ».

11. A potential casualty of the current market reform, especially regarding the prohibition on inducements (independent advisers) and the new regime on inducement (non-independent advisers), could be the level and quality of competition and market openness. "Open architecture" is currently one of the positive strengths of the European market. That it does not work perfectly to achieve good outcomes in all cases, is not disputed but there is choice and openness. "Open Architecture" does offer choice and openness and there is a risk that the current reform might result in a vertical integration of supply from the product manufacturer through advice to sales, limiting the ability of the consumer to find the best product. In certain Member State markets, vertically integrated distributors already control more than 80 % of the retail markets and de facto they are not subject to the MiFID "inducements" rules as their distribution networks are salaried, and the payments from the provider units do not reach them directly. ESMA should adopt a strong policy principle to avoid the attrition of the small segment of the retail market made of financially independent distributors who are at the same time multi-providers or "open architecture" operators. For example, in France, only 9% of the retail market is not dominated by large financial institutions. As an additional collateral damage, this also endangers the independent asset managers, whose performance is often above average, who will face a big challenge to distribute their funds in an even more "closed architecture" environment.

12. The SMSG also wants to underline that the political compromise at Level 1 did not imply a de facto ban on inducements in the context of non-independent advice, as stated in a press release of the CSU rapporteur in the EU Parliament, Markus Ferber, who has taken the view that ESMA draft advice goes beyond Level 1.[2]

13. Therefore, the SMSG requests that ESMA adopts interpretation of "independence", regarding the prohibition on inducements, which does not lead to reducing the "open architecture".

4. Provision of Advice and of Product

14. The SMSG considers that it is important to safeguard the access to advice and product for all savers including the smaller retail investors. However, greater regulation around investment advice, including the ban on rebates, could have the unintended consequence of shrinking the availability of investment advice.

15. The SMSG notes that in the UK, there was a drop in advisers numbers after the of Retail Distribution Review (RDR) came into force. The RDR implied a ban on advisory firms receiving commission for both independent and "restricted advice". In effect the UK gold-plated MiFID I, which is possible. It is true that rather than being specifically the result of the commission ban, this was also due to the new higher qualifications needed to advise clients. The RDR required advisers (both in-house and open architecture) to pass an exam (equivalent to first year of university education) in order to remain in the market. This led to the exit of a number of advisers unwilling or unable to pass this exam. The SMSG considers such requirement for anyone advising or selling financial products to take a series 7 type exam as exist in the US or in France to be positive. It should even be mandatory across the EU.

16. Although the SMSG welcomes the increase in the quality of advisers in the UK, it is concerned that the commission ban still might have had the unintended consequence of shrinking the availability of investment advice. In the UK, the majority of remaining advisory firms and platforms have adapted successfully to the regulatory changes. However, early signs are starting to indicate that a vacuum has in-

[2] http://www.markus-ferber.de/verschiedenes/presse-aktuell-single-view/?tx_ttnews[tt_news]=2296&cHash=8ba1320b11245451d167162e31cd7c49

deed been created.[3] There is one group of people seeking advice who can afford to pay for it, are willing to do so and in a post-RDR now have access to a more professional and transparent service from better qualified Independent Financial Advisers (IFAs). However there is also a larger second group, with smaller amounts to invest, who either take no action or are increasingly reliant on the internet. Some analysis suggests that it is the less wealthy, the so called 'mass market customers' who are most unlikely to pay – precisely the people we believe should have access to practical and affordable advice. To sum up, middle income savers seem now to have great difficulty in finding decent advice on their savings needs, even as their need for guidance increases.

17. This could lead to a two-tier system where payment for advice is considered prohibitive or perceived as such. It may have the negative side-effect of advice being focused on higher income target groups.

18. For the SMSG, a dual market where advice is being focused solely on high income categories and others being left with "execution only" would not be satisfactory. Digital innovations may well help over time but so far, the inertia in behaviours, and general concerns about making the 'wrong' choice or decision, make take-up of this very slow, particularly in the generation of people reaching the point at which they will need to make personal decisions regarding their finances for later in life. Therefore, although the market reactions and developments in the UK are still at a very early stage, these developments invite ESMA to be thoughtful and careful of too dramatic changes since the outcomes are unclear, and some of them may further be unintended.

19. The SMSG notices that the Financial Conduct Authority (FCA) seems to acknowledge the reduction of the provision of investment advice to retail investors did take place and that it indeed is an issue, as it just issued a Guidance consultation which is designed at clarifying when there is a "personal recommendation".[4]

20. Similarly, consideration should be given to retaining rebate based financial advice by non-independent intermediaries where permitted by national legislation or at least gradually phase out rebate financed non-independent advisers in order to maintain a sufficiently broad access to advice while a different, cost-effective way of delivering face-to-face advice on simple needs is considered.

21. Therefore, the SMSG requests that ESMA adopts an interpretation of "independence", regarding the regime on inducements, which does not lead to a de-facto ban on them.

5. Harmonisation of Regulation across directives and regulations

22. The SMSG wants to stress that the combined effects of different regulations need to be considered to ensure a clear alignment and consistency with relevant product directives. The distinction between the roles of the product manufacturer, product distributor and financial adviser should be maintained with clear and consistent regulation applied and MiFID should be aligned with, rather than undermining,

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3 See . Association of Professional Financial Advisers (APFA), The Advice Market post RDR Review, June 2014.

4 FCA, Guidance consultation, Retail investment advice: Clarifying the boundaries and exploring the barriers to market development, July 2014.

the effectiveness of protection delivered by existing product (UCITS) and manager (AIFMD) legislation. Furthermore a lack of alignment with such directives could create a lack of clarity regarding whether a product is considered complex or non-complex and therefore, to be most effective, focussed and specific product design requirements should be contained in product directives

23. The proposed regulation on Packaged Retail Investment Products and insurance based investment products (PRIIPs) aims to deliver a degree of harmonisation aligning MiFID II and the directive on Insurance Mediation (IMD II) as well as clarifying responsibility for product design and performance and for advice. Given that PRIIPs promises a consistent approach across all products, which is the key to delivering a comparison of products, MiFID should avoid pre-empting the PRIIPs disclosure requirements and thus create an un-level playing field around disclosures and costs. In the same vein, further delay to IMD II would cause more lack of clarity and create an unlevel playing field between investment and insurance products. Although the issue is of Level 1, the SMSG supports a functional approach to align PRIIPs and IMD2 and Mifid2 as this would be in the interest of the investors.

General comments of the Group on the draft advice on MiFID II/MiFID

2.6. Recording of telephone conversations and electronic communications

24. *ESMA is invited to provide technical advice on the effective organisational requirements that firms need to establish, implement and maintain in order to ensure full compliance with the telephone recording and electronic communications* requirements*, having in mind the importance of such records which may constitute crucial, and sometimes the only, evidence to demonstrate the development of firm-client relationships and to verify compliance by firms with their obligations under MiFID II as well as to detect and prove the existence of market abuse. Such organisational requirements should address the possible involvement of the management body and the compliance function, the storage requirements, including providing legal clarity on the beginning of the period of time for the records retention.*

Questions 8 to 13 (pages 32-38)

25. The SMSG notes that in most countries, business mobile phones are basic elements of the remuneration package and for the front office employees. They are one of the core devices to do business with the clients. European legislation provides a framework to protect the privacy of the communication and of data held about individuals. There are two relevant directives regarding this topic: the E-Privacy Directive and the Data Protection Directive. These legislations do not prevent the recording of telephone conversations and electronic communications, but do limit the circumstances in which recordings can be made and place necessary safeguards around the handling of the recordings.

26. The SMSG would like to draw the attention of ESMA on the need for investment firms to ensure the privacy of the employee while at the same time being compliant with the MiFID recording obligations.

27. The SMSG is also aware that sometimes a recorded transaction takes more than one hour, but the real transaction takes only 1-2 minutes in this hour phase. This creates additional costs for investments firms and, although, this is unavoidable since it is required by Level 1, ESMA should keep in mind this concern.

28. An another issue, article 16(7) of the MiFID II states, in the relevant provision, that

An investment firm shall notify new and existing clients that telephone communications or conversations between the investment firm and its clients that result or may result in transactions will be recorded.

Such a notification may be made once, before the provision of investment services to new and existing clients.

29. There is no provision on the language requirement when the notification is made before each call, which by the way is the best system in terms of informing clients and protecting private life. The SMSG suggests that for investments firms which have a large international client base, or to make it simpler who describe themselves as being in the private banking sector, the notification requirement is satisfied when the notification is made in the language of the majority of the clients as well as in English. A notification in all languages spoken by the clients of the investment firms would be burdensome and excessive. An indication that a notification in two languages is sufficient would create legal certainty for these firms.

2.7 Product governance

Questions 14 to 21 (pages 39-51)

Extract from the Commission's request for advice (mandate)

30. ESMA is invited to provide technical advice on detailed product governance arrangements for investment firms manufacturing and distributing financial instruments (and structured deposits) in order to avoid and reduce, from an early stage, potential risks of failure to comply with investor protection rules.

31. Strengthening the role of the management bodies or of the compliance function, should be duly considered. The technical advice should also specify the obligation for manufactures and distributors to regularly review their product governance policies as well as the products they manufacture, offer or recommend, and refer to any appropriate actions to be taken by manufacturers or distributors.

32. As these requirements are also relevant for investment firms offering or recommending investment products manufactured by firms which are not captured under MiFID II (non-MiFID entities/third-country firms), ESMA should consider what reasonable steps the distributor should take in order to ensure that investors' interests are similarly protected.

33. In developing its technical advice, ESMA should ensure there is sufficient clarity regarding the respective obligations of investment firms when acting as manufacturers, distributors or both.

34. Product governance is a new development in MiFID II and MiFIR. The SMSG considers this new requirement as very important in order to limit the risk of mis-selling to retail investor, so that products are designed with the interests and needs of investors in mind. The SMSG welcomes the fact that the

European Supervisory Authorities adopted a joint approach and published in November 2013 an Article 56 Joint Position on "Manufacturers' Product Oversight and Governance Processes".5 ESMA also published in March 2014, an Article 29(1) opinion on "Structured Retail Products - Good practices for product governance arrangements ».6

Ex-ante duty to check that products function as intended

35. ESMA proposes imposing a positive duty on firms to check that products function as intended, rather than only requiring them to react when detriment becomes apparent or at issuance or re-launch of the same product. The SMSG is in agreement with this requirement.

Product governance obligations

36. ESMA considers that distributor product governance arrangements may apply to more than one firm where different firms work together in the distribution of a product (for example, if a product is recommended by one firm but the transaction takes place using the platform of another firm). In such cases, the final distributor in the chain (i.e. the firm with the direct client relationship) has ultimate responsibility to meet the product governance obligations but the intermediate distributor firm(s) must:

i. ensure that relevant product information is passed from the manufacturer to the final distributor in the chain

ii. similarly, if the product manufacturers require information on product sales in order to comply with their own product governance obligations, the intermediate firm must enable them to obtain it; and

iii. apply the product governance obligations for manufacturers, as relevant, in relation to the service they provide.

The SMSG is in agreement with this requirement.

Application of the distributor requirements to distribution of products on the secondary market (e.g. freely tradable shares and bonds)

37. The issue is raised in Question 14 which mentions that "Should the proposed distributor requirements apply in the case of distribution of products (e.g. shares and bonds as well as over-the-counter (OTC) products) available on the primary market or should they also apply to distribution of products on the secondary market (e.g. freely tradable shares and bonds)?"

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5 JC-2013-77, available at: http://www.esma.europa.eu/system/files/jc-2013-77_pog_-_joint_position_0.pdf

6 ESMA/2014/332, available at: http://www.esma.europa.eu/system/files/2014-332_esma_opinion__structured_retail_products_-_good_practices_for_product_governance_arrangements.pdf

38. The SMSG supports this approach as distributors could (and even sometimes should) offer/promote secondary market products as well as "primary" market, especially as the latter would better be named as "packaged" products as far as the retail markets are concerned. It is very important that the product governance requirements apply as well to freely tradable shares and bonds, even if obviously some of the requirements listed by ESMA are relevant only for retail packaged products (so called "primary market" although there is almost never any "secondary" market for those) and should then be excluded.

Training

39. There is a need for both broad-based training in order to establish a culture of awareness regarding MiFID requirements and the importance of compliance. Training should be compulsory for concerned employees who sell any financial product on an annual basis. It also needs to be ensured that the training is of good quality. This ensures that questions can be asked directly, which is important especially for new employees.

40. The knowledge needs to be verified on a regular basis and if the required level of knowledge is not attained in a first instance, there should be no sanctions but rather a re-training by someone.

41. There is also a question of resources to be able to effectively make use of the training provided. It needs to be ensured that required technical conditions (such as proper IT systems) are made available for employees in order to e.g. give proper advice for the clients' needs.

Qualification as a complex product

42. The product manufacturer might have to classify whether a product is complex or not. At this time there are identical products which are considered complex in one Member State and non-complex in others. ESMA might want to exercise its powers in terms of supervisory convergence on this issue at some point.

2.9. Conflicts of interest

Extract from the Commission's request for advice (mandate)

43. ESMA is invited to provide technical advice to consider further improvements of the existing conflicts of interest framework, including the establishment of a requirement for periodical review of conflicts of interest policies or clarifications with respect to the last resort nature of disclosure which should not be over-relied on by firms nor used as a measure to manage conflicts of interests. However, for those situations where the organisational and administrative arrangements established by firms proved insufficient to prevent and manage conflicts of interests so as to ensure with reasonable confidence that risks of damage to client interests will be prevented, ESMA should also consider how to further strengthen the content and quality of the information provided to clients to enable them to make an informed investment decision with respect to the service in the context of which the conflict of interest had arisen. With a view to establishing appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of the investment firm, ESMA should assess the need to update or expand the minimum criteria set out in Article 21 of Commission Directive 2006/73/EC.

44. *ESMA should also provide technical advice on whether the current requirements concerning the management of conflicts of interests that might arise from the production and dissemination of investment research continue to appropriately protect the objectivity and independence of financial analysts and of the investment research they produce.*

Content of the disclosure obligations

45. In the Consultation Paper (Point 8, page 72), ESMA « considers that, for some clients, in particular those who are less sophisticated, the current requirements are too high-level and therefore may be ineffective. This is particularly relevant for retail clients, who may not understand the risks associated with the conflicts of interest. In particular, NCAs, in their supervisory activities, have seen examples where the disclosures are very generic. NCAs have also found that they do not include the specific details on the nature of the conflict. They have also found that the disclosures are drafted in such language that the client is unclear as to the risks that arise from the conflict or the detriment that may be incurred. To address these behaviours, ESMA proposes that the disclosure requirements are strengthened »

46. The SMSG agrees. In addition, the SMSG would like to emphasize that disclosure remains a limited tool and strong supervision of and regulatory enforcement at the new firm-facing requirements relating to, eg, inducements and product governance, is essential. ESMA, within the scope of its supervisory convergence powers, should make sure that NCAs conduct checks in order to assess the situation "on the ground", especially as this is a new requirement, and do not rely only on disclosure, even if strengthened.

2.10. Underwriting and placing – conflicts of interest and provision of information to clients

Extract from the Commission's request for advice (mandate)

47. ESMA *is invited to provide technical advice on possible organisational, conflicts of interest and conduct of business requirements that could better address the specificities of underwriting and placing processes and activities.*

48. The SMSG notes with great satisfaction that the issue of self-placement, which it raised with ESMA in 2012 and 2013 with a view to the case of the Spanish *Participaciones preferentes*, is being singled out in the Consultation Paper (Point 34, p. 82). As mentioned in a paper written in 2012 by Carlos Arenillas for the SMSG :

> "*Participaciones preferentes* are preferred shares which are a type of subordinated debt. Between 2008 and 2009, the banks and savings banks in Spain issued around 12,000 million *euros* of preference shares, which amounts to approximately 1.2% of GDP. 80% of these securities were sold through the branch network of banks and savings banks to retail investors. More than 300,000 retail investors bought these securities.
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> In 2010, the European debt crisis burst and the prices of shares and subordinated bonds of banks suffered significant losses. Quickly a large number of complaints and claims were presented at the CNMV (*Comisión Nacional del Mercado de Valores*) and at the courts. In 2010, the EBA announced that the preference shares would no longer be considered as Tier 1. Consequently,

banks decided to repurchase or exchange them for shares and COCOs. These operations involved losses for the seller. Discounts between 10% and 30% were applied.

The alarm among investors increased in 2011 with the nationalization of several savings banks and one bank, and reached the highest point (*in 2012*) when BANKIA (the fourth institution in the country) was nationalized. In August 2012, retail investors still held 5,600 million *euros* of preference shares. The stock was greatly reduced. The MOU for financial aid signed between Spain and the EU in summer 2012 states that the holders of subordinated debt of financial institutions have to take losses before the institution can receive public money. This makes today's losses to be borne by investors higher than 50%.

Summarizing, the accumulated losses of thousands of investors are large and, so are the complaints of poor marketing or mis-selling. The case of the *"participaciones preferentes"* is a first-order political issue in Spain. Available information suggests that in some cases there have probably been incorrect or fraudulent actions. The CNMV has opened 17 disciplinary proceedings that would cover around 5,900 million euros issued and thousands of investors. These proceedings affect 15 financial institutions (of 9 financial groups). In the courts there are thousands of complaints pending resolution by the judge. The Spanish government has already approved new legislation and the CNMV has set new regulations for public consultation to prevent similar situations from occurring in the future.

There is European regulation on the marketing of financial products by the investment services firms. But there is not much in relation to the marketing of own securities, the so-called self-placement. Especially by credit institutions. It seems clear that there is a need to reflect and improve regulation and supervision. This exercise should be done at European level".

49. The draft Technical Advice says that "12. Investment firms (and credit in*stitutions) that engage in* the placement of financial instruments issued by themselves (or other group entities) to their own clients, including their existing depositor clients or investment funds managed by entities of their group, must have in place clear procedures for the identification and management of the potential conflicts of interest that arise in relation to this type of activity. Such procedures may include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients. "

50. The SMSG agrees with the approach but has some remarks.

51. First, instead of « Such procedures may include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients » the SMSG would support « Such procedures must include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients ».

52. Second, the SMSG would support a stronger statement, with more precise requirements, in relation to self-placement by financial institutions when this is the result of a regulatory requirement or has been requested by the national banking regulator.

53. Several Member States have already recognized the serious conflict associated with such practice. For instance, in Denmark it has been made illegal to offer lending in connection with offering own securities, due to some instances of abuse detected during the crisis, and financial institutions are reminded of their responsibility not to push own securities to their customers. In the United Kingdom, in the first use of new consumer protection powers, the Financial Conduct Authority (FCA) announced on 5 August 2014 that it will restrict firms from distributing contingent convertible securities (CoCos) to the mass retail market from 1 October 2014 to 1 October 2015. Contingent convertible instruments are hy-

brid capital securities that absorb losses when the capital of the issuer falls below a certain level. They are risky and highly complex instruments. They are issued by financial institutions and there is a serious risk that they will be placed to retail depositors of these banks as the Spanish *participaciones preferentes* were. Therefore, this temporary prohibition introduced by the FCA is indirectly adressing the issue of self–placement.

54. The approach developed in Spain since 2012 by the CNMV (*CNMV Circular 1/2014 on the requirements on internal organization and the functions of control of entities which provide investment services*) and the Spanish legislator (Law 9/2012 of 14 November on restructuring and winding-up of credit institutions), acting on advice of the CNMV, could be used as a model.[7] Spain has set up several regulatory changes on the issue and marketing of hybrid (*Participaciones preferentes*) and other complex products addressed to retail investors in order to prevent potential investor detriment. This new set of measures includes the *following issues:*

(i) The marketing or placement of complex products qualifying as equity for the purpose of credit institution capital adequacy requirements is subject to new conditions. Firstly, issuers shall reserve at least a 50% tranche for professional investors, whose total number will be no less than fifty. This measure makes sure that professional sophisticated investors purchase the offer so that it is safer for retail investor to purchase too and that it is not targeted at them because it cannot be sold to anyone else. In the case of the Spanish bank Bankia the increase in capital in 2011 was sold almost only to Spanish retail investors as professional investors stayed away from the offer.[8]. Secondly, the denomination unit cannot be less than 100,000 euros in the case of preference share issues or convertible debt issues of non-listed companies. – See Thirteenth Additional Provision of Law 9/2012 on restructuring and winding-up of credit institutions.

(ii) The CNMV is empowered to require all pertinent warnings to be inserted in advertising material or the pre-contractual documents. – *See Third Final Provision (point five) of Law 9/2012*

(iii) In the case of financial instruments other than shares, issued by credit institutions, the information provided to investors shall include additional information on the differences between the financial product offered and bank deposits in terms of yield, risk and liquidity. – *See Third Final Provision (point five) of Law 9/2012*

(iv) When providing investment advice or discretionary portfolio management, investment firms

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7 For a more precise presentation, see also. CNMV annual report 2012, p. 147 *et seq*.

8 By S. Schaffer Munoz, D. Enrich and C. Bjork, Spain's Handling of Bankia Repeats a Pattern of Denial, June 11, 2012. « But Mr. Rato and his advisers shifted tactics. Instead of focusing on the sophisticated international money managers that are the usual candidates to buy stock in newly listed companies, they switched their focus to Spaniards. Bankia and several other large Spanish retail banks peddled the shares to hundreds of thousands of their customers at €3.75 apiece. Mr. Rato and top Spanish government officials worked the phones with wealthy individuals and business leaders, urging them to buy shares personally and on behalf of their companies. If Bankia's offering failed, they warned, it could drag down the entire Spanish financial system. Bankia managed to raise only €3.1 billion. Less than 2% of the proceeds came from investors outside Spain, according to people familiar with the matter. (…) On May 7 (*2012*), under government pressure, Mr. Rato tendered his resignation as Bankia's chairman. Days later, the government ordered banks to come up with another €30 billion of reserves to absorb future losses.

shall provide clients with a description of how all recommendations meet the investors´ features and objectives. When providing other services, investment firms are obliged to give a copy of the report on the appropriateness assessment to their clients. – *See Third Final Provision (points six and seven) of Law 9/2012 and Third and Fourth Regulation of CNMV Circular 3/2013*.

(v) Where the result of the assessment is that a product is not appropriate, the contractual document should include, along with the client's signature, a hand-written representation that they have been warned that the product is inappropriate or that its appropriateness cannot be assessed for the lack of data. Besides, investment firms shall keep a specific register to record all of these clients warned. – *See Third Final Provision (point seven) of Law 9/2012 and Fourth and Fifth Regulation of CNMV Circular 3/2013.*

(vi) Investment firms should establish appropriate procedures and controls regarding product governance, remunerations and staff training – *See CNMV Circular 1/2014*

55. Points (iii), (v) and (vi) could especially be included in the Technical Advice as these measures are fully within the scope of the Commission's request for advice.

56. The 2012 annual report of the CNMV also mentioned the following interesting legislative suggestions:

« In addition, in 2012, in response to the request received, the CNMV passed on to the subcommittee on transparency in information on financial and mortgage products of credit institutions of the Lower House of Parliament a breakdown of the legislative proposals which the CNMV believes will improve investor protection, which includes the following proposals:

1) Legislation should establish the internal requirements of entities for launching new products, specifying the target public they will be aimed at, the incentives for the sales network and other aspects. It would be a preventive regulation which could contribute towards preventing some of the risks which have materialised in the past.

2) Strengthening of the client's informed consent by requiring a minimum period of reflection prior to contracting complex products, which will allow the client to review the documentation of the operation and request the advice which he/she considers appropriate. This could contribute towards the investor detecting any discrepancies between the verbal information received and the contractual documentation of the operations.

3) The possibility of strengthening investor protection by requiring the marketing of particularly complex products to include advisory services. In this case, investor protection is greater as the intermediary must ensure that the product matches the client's financial situation and investment objectives. Alternatively, a requirement could be established for these products whereby clients declare in their own handwriting that the purchase was not recommended by the entity » (…).

57. *The SMSG calls on ESMA to consider developing a specific Guideline on the issue of self-placement, as the Level 1 text provides for legal support to do so, with a working group possibly to be chaired by the CNMV.*

58. In the meantime, the SMSG supports and invites ESMA to exercise strongly its powers in terms of supervisory *convergence*, especially in relation with the Asset Quality Review (AQR) of the European Banking Authority (EBA) and the stress test of the European Central Bank (ECB) that will be completed in November 2014.

2.14. Information to clients on costs and charges

59. The SMSG welcomes the introduction of article 24(4)(c), subparagraph 2 of MiFID II, that requires that "*all costs and* charges" shall be aggregated in order to allow the client to understand the overall cost as well as the cumulative effect on return of the investment. The SMSG supports the approach adopted by ESMA.

60. The draft technical advice also provides at (Point 58, p. 112 "*Post-sale periodic disclosure of information (ex-post disclosure)* that « The current ex-post information, as prescribed by Article 40 and Article 41 of the MiFID Implementing Directive is provided on a personalised basis, and is based on actual costs incurred. In line with this ESMA proposes that the additional periodic reporting requirements as proposed in this CP should also be provided on a personalised basis, using costs actually incurred.

61. However, the SMSG would like to suggest that clients receive annually a report with this summary on the first page:

Investment (€)		Yield before costs & expenses		Costs & expenses		Net yield (after initial as well as on-going commission)	
At beginning of the period	At end of the period	€	%	€	%	€	%

2.15. The legitimacy of inducements to be paid to/by a third person

Questions 79 to 82 (page 118-125)

Extract from the Commission's request for advice (mandate)

62.ESMA is invited *to provide technical advice on:*

> *- the conditions under which investment firms providing investment advice on an independent basis and portfolio management fulfil the requirement to not accept and retain any monetary or non-monetary third party fees commissions or benefits as well as on the definition and conditions for acceptable minor*
> *non-monetary benefits*
>
> *"the conditions under which payments and non-monetary benefits, paid to or provided by investment firms providing all other investment or ancillary services, are not deemed to meet the requirement of enhancing the quality of the relevant service to the client"*

Authorization of inducements provided a "quality enhancement"exists

63. The requirement *that* inducements are authorized provided that they enhance the quality of the relevant service to the client was already included in MIFID I but has not been enforced, to our knowledge, by NCAs.

64. There is another – as important – requirement in MIFID II (and also in MIFID I) which is that the inducement "*does not impair compliance with the firm's duty to act honestly, fairly and professionally in accordance with* the *best interest of its clients*." (Article 24(9) of MiFID II). The SMSG is concerned that this equally unenforced requirement has not been made part of the mandate from the European Commission.

65. As stated, a major issue with inducement is that regulators did not sufficiently enforce this requirement, which for the SMSG implies that the issue was mostly an enforcement issue. The SMSG notes that the European legislator is fully aware of this, since inducements have not been banned but the level of transparency (independent and non-independent advice; increased transparency on non-independent advice) has been increased. Therefore, in general, ESMA should avoid interpretations that will in effect ban inducements.

66. In this regard, the negative list of circumstances and situations that NCAs should consider in determining when the quality enhancement test is not met (ESMA's draft technical advice para. 10(i), p. 124) disregards the EU legislator's decision regarding payment of inducements. The EU legislator has decided to allow both commission-based and fee-based advice, the former as long as the payments are designed to enhance the quality of the service and do not impair the firm's duty to act in accordance with the best interest of its clients. The MiFID II Level 1 text clearly states that investment firms should have the choice between independent and non-independent advice (see recital 73) which are considered equal.

> Recital 73 « In order to further establish the regulatory framework for the provision of investment advice, while at the same time leaving choice to investment firms and clients, it is appropriate to establish the conditions for the provisions of that service when firms inform clients that the service is provided on an independent basis. When advice is provided on an independent basis a sufficient range of different product providers' products should be assessed prior to making a personal recommendation. It is not necessary for the advisor to assess investment products available on the market by all product providers or issuers, but the range of financial instruments should not be limited to financial instruments issued or provided by entities with close links with the investment firm or with other legal or economic relationships, such as a contractual relationship, that are so close as to put at risk the independent basis of the advice provided ».

67. As mentioned above, this political compromise at Level 1 did not imply a de facto ban on inducements in the context of non-independent advice, as made clear by a press release of the CSU rapporteur in the Parliament, Markus Ferber, which has taken the view that ESMA draft advice goes beyond Level 1.[9]

68. One reason for this political decision is that a prohibition of such payments would significantly decrease the private clients' access to investment advice including advice for private retirement savings. Studies show that only a minority of investors are prepared to pay for advice. These are usually professional investors in private banking, and not even represented in all markets (eg Italy).

69. The SMSG is concerned that the Technical Advice proposed by ESMA on the conditions to meet this requirement of "quality enhancement" (ESMA's draft technical advice para. 10(i), p. 124) represents a de-facto ban of inducements, which also seems to have been achieved on purpose.

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[9] http://www.markus-ferber.de/verschiedenes/presse-aktuell-single-view/?tx_ttnews[tt_news]=2296&cHash=8ba1320b11245451d167162e31cd7c49

70. The SMSG has two general observations on this point:

71. Non-independent advisors must continue to be allowed to be remunerated through commission payments. Under ESMA's proposal it is very unclear how any payment of distribution commissions may be regarded as being designed to enhance the quality of the service. Firstly, it is not clear which payments would fulfil the negative criterion that they are "used to pay or provide goods or services essential for the recipients firm in its ordinary course of business" (ESMA's draft technical advice para. 10(i), p. 124). ESMA does not give any reasoning why the use of payments for goods or services essential in the ordinary course of business cannot be considered as designed to enhance the quality. The SMSG believes that there are situations where e.g. a service would not be provided at all to clients without the commission payment. It might then simply be too expensive for an investment firm to provide for investment advice, if commission payments are prohibited, in particular in less populated regions which have less developed financial distribution networks. In addition, the objective of the inducements provision is to enhance investor protection. The prohibition in this case would, however, lead to a completely different effect, since investors would not be advised at all and therefore would effectively become less protected. Hence, the criterion "designed to enhance the quality of the service" should not be defined in a way that payments cannot be used to provide for the service or the payment for goods, since this might be in the client's very interest. Therefore it should ultimately be deleted.

72. Secondly, the negative criterion of a firm not providing " for an additional or higher quality service above the regulatory requirements provided to the end user client » (ESMA's draft technical advice para. 10(ii), p. 124) disregards the fact that in many instances, the Level 1 text or ESMA in its proposals provide for the highest possible standards already. Due to this, it might in practice not be possible to generally increase such high standards. For example, according to ESMA's proposed technical advice, investment firms have to be able to demonstrate that they assess whether alternative financial instruments, less complex or with lower costs could meet their client's profile (for our assessment on this issue, please refer to our answer to Q86). According to ESMA, it is hence not sufficient to provide for a suitable product, but it seems as if the firm has to rule out that no other product available in the market is more suitable. The quality for such standard might simply not be enhanced beyond these regulatory requirements. In fact, in such case it would in practice not be possible to pay or receive inducements since there would be no room for it to be designed to enhance the quality. Consequently, the applicability of the second negative criterion would in such case lead to a prohibition of inducements, which was not intended by the EU legislator. Therefore the SMSG believes that in some cases the compliance with regulatory requirements should be sufficient to generally enhance the quality of the service.

73. In addition, as it stands, the Technical Advice proposed by ESMA on the conditions to meet this requirement of "quality enhancement" (para. 10, page 124) is extremely obscure, and might not be understood by individual investors.[10] Item 10 (i) in particular states that « A fee, commission or non-

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10 10. *ESMA advises the Commission to introduce a non-exhaustive list of circumstances and situations that NCAs should consider in determining when the quality enhancement test is not met. A fee, commission or non-monetary benefit may not generally be regarded as designed to enhance the quality of the relevant service to the client if:*

i. it is used to pay or provide goods or services that are essential for the recipient firm in its ordinary course of business;

ii. it does not provide for an additional or higher quality service above the regulatory requirements provided to the end user client;

iii. it directly benefits the recipient firm, its shareholders or employees without tangible benefit or value to its end user client; or

monetary benefit may not generally be regarded as designed to enhance the quality of the relevant service to the client if: i. it is used to pay or provide goods or services that are essential for the recipient firm in its ordinary course of business; ». Therefore, taking into account the requested modifications, the SMSG also advises ESMA to rewrite this paragraph in plain English and practical terms both for retail distributors and their clients.

74. The SMSG understands that Point 11 (page 124) is designed to support the "Open architecture" model and addresses the issue raised by the SMSG. Point 11 states the following:

> In understanding whether or not the enhancement test can be met in accordance with these criteria, it should be understood that a fee, commission or non-monetary benefit could be considered acceptable if it enables the client to receive access to a wider range of suitable financial instruments or the provision of non-independent advice on an on-going basis, so long as any such service is provided without bias or distortion as a result of the fee, commission or non-monetary benefit being received.

75. However, this drafting is also quite obscure and therefore neither easy to understand nor to reconcile with the very restrictive approach in Point 10. The term « to a wider range of suitable financial instruments » does not refer clearly to « open architecture ».

76. Therefore, the SMSG calls for a redrafting of Points 10 and 11 in a way which does not lead to a de facto ban of inducements when a distributor is not independent and protects the « Open architecture » model. To make this sure, a possibility could be that point 11 become the principle and not the exception.

Inducements and "Open architecture"

77. As mentioned in the introduction, the Technical Advice proposed by ESMA is quite worrisome as the SMSG is concerned that it may well create an even worse distribution model in Continental Europe, with the exception of the Netherlands which have followed the UK model, compared to the existing one:

- With the reduction of the already small "open architecture" models, individual investors being given the choice between different and unrelated providers of investment products

- To the further benefit of the dominant "closed architecture" models where individual investors are offered only in-house products. All evidence available (including from Lipper and from Better Finance) prove that on average these closed architecture distributors sell lower performing products than the open architecture ones. It has been - and will be - quite easy for closed architecture players to continue to operate and prosper without having to disclose apparent "inducements" as they are defined by MIFID I and MIFID II.

- This would be all the more damaging to investors since independent manufacturers of investment products, which do not have their own distribution channel, have typically, and also logically, shown better performance, as they cannot rely on "captive" group of customers but must either prove their competence or disappear. For instance, in France several of the best asset managers for equities are well known independent firms. The same can be noted in many other European countries, including Switzerland, and also in the United States. The

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iv. in relation to an on-going inducement, it is not related to the provision of an on-going service to an end user client.

fact that investment funds of independent firms would face a significant reduction of access to retail investors, due to a restrictive interpretation of "quality enhancement" would certainly not be in the best interest of neither the retail nor the professional investors.

- Also, this may finally give rise to sales without any financial advice (whether "independent" or "dependent") to EU citizens as selling without advice is a clear and easy way to avoid most of MIFID's investor protection regulations which are not targeting selling but only "advice".

Inducements and non-monetary benefits (financial analysis)

78. Investment firms providing independent investment advice or portfolio management are allowed to receive minor non-monetary benefits that are capable of enhancing the quality of service, provided that they are of such scale and nature that they cannot be judged to impair compliance with the firm's duty to act in the best interests of its clients. This term is included in article 24 of MifID II in relation to the provision of investment advice (7) and portfolio management (8) on an independent basis. Article 24§7 states that:

> " Where an investment firm informs the client that investment advice is provided on an independent basis, that investment firm shall:
>
> (b) not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client must be clearly disclosed and are excluded from this point. "

79. Article 24§8 states that:

> "When providing portfolio management the investment firm shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client shall be clearly disclosed and are excluded from this paragraph."

80. The SMSG is concerned by the extreme interpretation by ESMA of the notion of minor "non-monetary benefit". According to the Consultation Paper, only "minor" benefit could be paid via commissions and it defines minor benefits in the area of financial analysis as research of general content, widely distributed ie equivalent to newspaper articles (Point 12 and ff, and especially point 13, page 121).

81. This type of research is of no value and is never paid for by fund managers which are capable of reading annual reports. It is true that unbundling (paying for research separately) has developped significantly in the United States in the last years but bundling does de facto remain and is allowed under the 1934 Exchange Act (see 2.16 in fine on the US). It is also possible that some managers, of their own volition, could opt to move to a different business model and pay for research independently. However, the vast majority of fund managers would not have the financial capacity to pay for research out of their income, while at the same time management fees would be difficult to increase in the current competitive environment.

82. As a consequence, the European asset managers would be prevented from paying for research out of dealing commission. The consequences could be quite adverse for the European fund management industry. Even worse, in order to ensure a level playing field, ESMA therefore advises the Commission to consider the possibility of aligning the relevant provisions that fall under UCITS and AIFMD with the MiFID II implementing provisions on this topic (Consultation Paper, p. 122). This would extend the problem to all regulated fields.

83. The SMSG completely disagrees with the qualification of research as an inducement , and does not even see it as being a non-monetary benefit. It notes that the Level 1 text never considered investment research as an inducement and logically never directed either the Commission or ESMA to work in this direction. Research is not an inducement for the distributor, but an additional service that is aimed for the benefit of the client.

84. Generally, publicly available research cannot and should not be considered as a benefit and is therefore no inducement in the first place. As described above, by definition, a benefit requires an advantage. Hence, the person receiving the benefit must end up in a better position than others. This is not the case, if the research is publicly available, since there is no advantage for the portfolio manager. Hence, such research might can not be considered as benefit at all and is therefore not subject to the requirements regarding inducements in the first place. The same applies to tailored research which is to the benefit of a specific fund or a specific portfolio. Such tailored research does not give an advantage to the portfolio manager but to the portfolio and hence the client. Therefore it cannot be regarded as benefit for the portfolio manager.

85. Tailored research may only be considered as a prohibited benefit, if it could influence the recipient's behaviour in any way that would be detrimental to the interest of the relevant client. ESMA does not provide any explanation why tailored research may influence the recipient's behaviour, except for the suggested risk of "churning" clients' portfolios. The churning of clients' portfolio, i.e. the execution of transactions for another purpose than increasing the client's return or reducing any losses, however, would be illegal in itself. ESMA falls short of giving any empirical justification that churning in fact takes place, but only states that firms may be influenced to churn. Though tailored research may influence investment firm's behaviour, such behaviour is not necessarily to the detriment of the client. In fact, research directly assists the investment manager when making its investment decision and is therefore to the advantage of the client and not to his detriment. As investment firms are required to act in the client's best interest, they are therefore bound to execute orders on terms most favourable to the client (MiFID II, Art. 27). The text allows taking other considerations relevant to the execution of order into account. Hence, best execution could also comprise cases where a higher commission is justified by the research provided to the investment firm.

86. ESMA's interpretation would also prohibit face to face meetings between investment firms and analysts to discuss investment ideas which should be encouraged rather than discouraged, since this would promote out of the box thinking, honest and candid discussions, and is currently a common market practice.

87. ESMA's interpretation would result in the decrease of available quality research especially for SMEs and will most likely be detrimental to small and medium fund managers who cannot afford to have their own research department. This is a typical example of the kind of rules whose consequences cannot be foreseen but which clearly will destabilise the economics of the asset management industry without bringing any benefit to the final investors. Quite to the contrary, as mentioned, it will reduce the amount of available research which could lead to unintended consequences such as: putting pres-

sure on smaller players to concentrate, reducing competition; depriving listed small and medium businesses from financial analysis as they need research support to attract investor, which is in addition acknowledged in the Mifid II (SME growth markets).

88. Finally, ESMA has to take into account that capital markets are global and hence the need to avoid creating an unlevel playing field in relation to other conflicting regimes, especially with the US and Asia. The interpretation made by ESMA would create a distortion if it were, for example, possible to secure research on a European Stock/issue from a European bank operating within another regulatory environment. In the US, fiduciary principles require money managers to seek best execution for client trades, limiting managers from using client assets for their own benefit. Regarding financial reserach, the Section 28(e) safe harbour from the Securities Exchange Act of 1934 protects managers against a breach of fiduciary duty when the asset manager pays more than the lowest commission rate in order to receive 'brokerage and research services', on the following conditions:

> 1) The money managers must determine whether the product or service falls within specific limits of Section 28 (there have been a number of follow up SEC interpretations re. research eligibility).
>
> 2) The money managers must determine in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received.
>
> 3) Research as a product/service must provide lawful and appropriate assistance in the performance of investment decision-making (i.e. must have substantive content).

89. In particular point 3 appears to be in direct conflict with the ESMA test for an inducement. An SEC guidance paper (2005) states that the proposed interpretation of Section 28 is compliant with the FSA's rules in the UK (at that time) - recognising that despite significant differences to the governing rules and laws between the US and UK, it is still desirable to reduce market participants' costs of compliance from multiple regimes. Given that the regulation is enshrined in primary legislation, it is unlikely that the US would consider a move to harmonisation on a global standard.

90. Therefore, the SMSG as part of its advice urges ESMA to reconsider their stance by deleting the paragraph relating to investment research.

2.17. Suitability

Questions 86 to 89 (pages 131-135)

Extract from the Commission's request for advice (mandate)

91. *ESMA is invited to provide technical advice on the information to obtain when assessing the suitability or appropriateness of the services and financial instruments for their clients, criteria to assess non-complex financial instruments, the content and the format of records and agreements for the provision of services to clients and of periodic reports to clients on the services provided. In particular, the technical advice should consider any updates or improvements to the suitability assessment requirements as well as proposals for the content of suitability reports aiming to ensure a real added value for the client.*

92. *Moreover, technical advice should further clarify and update the criteria to assess non-complex products set out in Article 38 of the Commission Directive 2006/73/EC.*

93. *The advice should take into account: (i) the nature of the services offered or provided to the client, taking into account the type, object, size and frequency of the transaction, (ii) the nature of the products being offered, including types of fin instrument and structured products and (iii) the retail and professional nature of the client, eligible counterparty.*

94. Mifid II does not fundamentally change the requirements on firms on the assessmentof appropriateness and suitability. The responsibility for assessing the suitability and appropriateness of the product lies with the financial adviser. However, the requirement needs to be balanced with a responsibility on behalf of the saver to disclose the appropriate information. The financial intermediary should have the flexibility to find the right balance between the desired product, the information disclosed by the client and the relevant level of protection sought. From this follows, that the high standards for accessing suitability and appropriateness will require time to be spent with a client and a price will need to be paid. The introduction of Retail Distribution Review (RDR) in the UK by the Financial Services Authority (FSA) and now the Financial Conduct Authority (FCA) could, as mentioned, provide an opportunity to assess and learn from the impact on the provision of advice to smaller investors. Therefore, the SMSG invites ESMA to study the effect of the RDR in the UK and in other Member States which have introduced similar approaches, such as the Netherlands.

Notion of cost

95. The term “lower cost” is too general and has lots of dimension (direct, indirect). The SMSG recommends a clear guidance and definition of the term, as based on the present text, application in the Member States otherwise could be extremely different from one state to another.

Restricted advice

96. The SMSG wants to underline that its position on suitability should not be interpreted as meaning that “restricted advice” and restricted advice business models cannot continue to be offered. Restricted advice" which can be offered in the UK has a valuable place in keeping the cost of advice down for consumers. A restricted adviser or firm can only recommend certain products, product providers, or both.

97. Some examples of restricted advice are where:

The adviser works with one product provider and only considers products which that company offers.

The adviser considers products from several – but not all – product providers.

The adviser can recommend one or certain types of products, but not all retail investment products.

The adviser has chosen to focus on a particular market segment, such as pensions, and considers products from all providers active within that market.

Restricted advisers and firms cannot describe the advice they offer as 'independent'

Availability of lower cost alternatives

98. The draft Technical Advice 1. iii states that

> *"investment firms should have, and be able to demonstrate, adequate policies and procedures to ensure that they understand the nature, features, including costs and risks of instruments selected for their clients and that they assess whether alternative financial instruments, less complex or with lower costs, could meet their client's profile"*

99. Similarly, the draft Technical Advice 1. ix states that

> "*when recommending a financial instrument to a client, investment firms should assess whether an alternative instrument, less complex and with lower costs, would better meet the client's profile*"

100. The SMSG believes that the assessment to be made whether there is an alternative instrument with lower costs is crucial and congratulates ESMA for including this requirement in its draft Technical Advice. Indeed, ample evidence shows the dramatic impact of costs on the performance of retail investment products. In the view of the SMSG, the extent of the range of products offered by the investment firm should not be an excuse for not providing this assessment. Therefore, we strongly advise that this assessment be provided in the suitability report regardless of the lower cost alternative instruments being part of the investment firm's offering or not. Otherwise, this requirement will be useless. In particular, all evidence has confirmed that plain vanilla index Exchanged Traded Funds (ETFs) are not currently proposed/sold to individual investors in Europe. It means that they are very unlikely to be included in the retail products range of the investment firm. If ESMA limits the scope of "alternative investments with lower costs" to that firm's product range then, the requirement becomes quite useless and ineffective to fully protect the investors' interests.

101. In addition, the SMSG suggests that firms that do not offer independent advice be required to warn their clients that other suitable lower risk and/ or lower cost financial products are or could be available on the market, but that the firm is not in a position to assess and recommend those.

102. However, the SMSG is also mindful of the fact that suitability and costs are not identical issues. This is especially true since investment products are rarely matched by an equivalent plain vanilla product. This is due to the fact that the managers of investment funds usually have freedom to invest in a broad universe of financial instruments, within the asset class targeted by the relevant investment fund (eg: stocks, bonds…). Also, investors in actively managed funds subscribe to a management team, or manager, and not just to an asset class as such. Therefore, although lower costs alternatives should be considered, it is not always possible to do so. Suitability is also different from costs and a lower costs alternative might not necessarily be suitable. Therefore, the SMSG suggests the following drafting which, while taking into account the necessity for the investment adviser to consider alternative instruments at a lower cost, does not imply (but which the current draft advice could be interpreted as implying) that a lower cost alternative is necessarily better or more suitable :

> *iii.* investment firms should have, and be able to demonstrate, adequate policies and procedures to

ensure that they understand the nature, features, including costs and risks of instruments selected for their clients and that they assess, ***while taking into account complexity and costs,*** whether alternative financial instruments~~**, less complex or with lower costs,**~~ could meet their client's profile.

ix. when recommending a financial instrument to a client, investment firms should assess whether an alternative instrument, less complex and with lower costs, would ~~**better**~~ meet the client's profile"

103. This drafting would also satisfy those members of the SMSG who believe that the proposed drafting by ESMA of the Technical Advice is simply contradicting the suitability assessment which is meant to provide investors with the best possible and best suitable advice. These paragraphs insinuate that this is not already the case and investment firms would generally be in breach of their duties when assessing suitability. This would also place too big an emphasis on the cost element of suitable financial instruments, as cheaper financial instruments are not necessarily better suited for the client. From an advice perspective it has to be considered that there are more determinants for suitable products than costs alone.

Cost Transparency and Product Suitability

104. Historically, there has been a lack of transparency on costs associated with certain products. However, there is a danger in focusing solely on the provision of financial advice in respect of lower cost products which might not necessarily be the most appropriate product for the investors. Lower cost product options should also offer comparable risk characteristics and performance returns provided by alternative products. Cheap is not necessarily best. Therefore, the need to indicate the existence of lower cost alternatives is positive but it should not lead to obliging financial advisers to recommend only low cost options.

Robust processes for assessing the risk a client is willing and able to take

105. The draft Technical Advice 1. viii: states that "viii. *investment firms should take reasonable steps to ensure that the information collected about their clients is reliable*" and that this includes " b. having robust processes for assessing the risk a client is willing and able to take, including their ability to bear the investment risk; » One particular area of concern to regulators in at least three major European markets (UK, France and Italy)[11] has been the widely spread use of inadequate processes for assessing clients' risk profiles. Despite deficiencies in risk tolerance assessments, CONSOB, the Italian regulator, found them to be compliant with MiFID I[12]. Therefore, it appears that improvement in the area of assessing customers' willingness and ability to take risk could be achieved through clearer rule

11 André de Palma and Picard, Nathalie (2010) "Evaluation of MiFID questionnaires in France. Study for the Autorité des Marchés Financiers"; FSA, (2011), "Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection"; N. Linciano, Soccorso, P., (2012), "Assessing investors' risk tolerance through a questionnaire", CONSOB.

12 "In conclusion, only two out of the 20 questionnaires analysed can be considered sufficiently clear, effective and "valid"... The remainder fail to provide clear measurements on risk attitude, risk capacity, risk tolerance and investment objectives, and are deficient in both wording and comprehensibility". "; *N. Linciano, Soccorso, P., (2012), p. 35*
"Overall, the questionnaires are compliant with the MiFID and, as MiFID does, only focus on a subset of the items judged as relevant by the literature."; *ibid. p. 30*

making and the SMSG is of the view that the Directive, implementing MiFID II should be more explicit. In particular, the SMSG suggests that point viii. (b) of the technical advice to the European Commission should read:

> "b. Demonstrating **valid and reliable** assessments of ~~having robust processes for assessing~~ the risk clients are willing and able to take, including their ability to bear the investment

2.24. Product intervention

Questions 107 and 108 (pages 166-173)

Extract from the Commission's request for advice (mandate)

106. *ESMA is invited to provide technical advice on measures specifying the criteria and factors to be taken into account by competent authorities in determining when there is a significant investor protection concern or a* threat *to the orderly functioning and integrity of financial markets or commodity markets or to the stability of the whole or part of the financial system of the Union or of the financial system within at least one Member State. As the Regulation establishes an identical framework for EBA intervention powers in respect of structured deposits and as factors and criteria to be taken into account for the exercise of product intervention powers for structured deposits should be similar to (if not identical to) those set for ESMA with respect to financial instruments, ESMA is invited to closely liaise with and consult EBA when providing its technical advice to the Commission and proposing factors and criteria for intervention powers in accordance with Articles 40, 41 and 42 of the Regulation.*

107. Product intervention is a new and important power granted to NCAs and to ESMA. The factors and criteria listed by ESMA in its draft TA, which are not exhaustive, are elements that should be taken into account by ESMA or a NCA when *considering* the possibility to exercise their product intervention powers. The MiFIR provides a list of at least four (4) such criteria and factors. ESMA considers that the following eleven (11) criteria, which include the four requested by MiFIR, are relevant:

> i. The degree of complexity of the financial instrument or type of financial activity or practice. Under this factor, more detailed elements to be considered could include, for example:
>
> a. the type and transparency of the underlying;
>
> b. multiple layers of costs and charges
>
> c. the performance calculation complexity
>
> d. the nature and scale of any risks
>
> e. whether the instrument or service is bundled with other products or services; and
>
> f. the complexity of any terms and conditions.
>
> ii. The size of the potential problem or detriment. (…)
>
> iii. The type of clients involved in an activity or practice or to whom a financial instrument is marketed or sold. (…)

iv. The degree of transparency of the financial instrument or type of financial activity or practice. (…)

v. The particular features or underlying components of the financial instrument or transaction including any leverage a product or practice provides. (…)

vi. The degree of disparity between expected return or benefit for investors and risk of loss in relation to the financial instrument, activity or practice. (…)

vii. The ease and cost for investors to switch or sell an instrument. (…)

viii. The pricing and associated costs. (…)

ix. The degree of innovation of a financial instrument, an activity or practice.

x. The selling practices associated with the financial instrument. (…)

xi. The situation of the issuer of a financial instrument. (…)

Criteria and factors to be taken into account by competent authorities (NCAs) in determining when there is a significant investor protection concern

108. The SMSG does not agree with **"**the criteria and factors to be taken into account by competent authorities in determining when there is a significant investor protection concern" proposed by ESMA in its draft Technical Advice, nor does it agree with their ranking. In addition, the criteria are overly complex and numerous. There are 50 "detailed elements" which are being given as examples of how criteria and factors should be interpreted by a NCA. Although this is required by MiFIR and these elements are provided in order to clarify how the NCAs should use these new powers, this list does not provide a lot of legal certainty for users.

109. All of the first six criteria for investor "concern" as stated in Point i, ie" The degree of complexity of the financial instrument or type of financial activity or practice " are not about likely detriment/concern in our view, but about complexity which is a quite a different issue. Aspirin is a very complex product. A car is also a very complex product. But the services they deliver to the consumer are quite clear and easy to understand, and they both - by the way – have been pre-approved by the supervisors. This confusion and amalgamation between investor concern/detriment with "complexity" is unfortunate. What is important is that the investment proposal is clear and understandable and actually this is a requirement of MIFID I and Ii. Whether the "engine below the hood" is complex or not is not the main issue for investor and consumer detriment although there must be transparency on this point and there are issues of financial stability to such instruments (eg leveraged ETFs). At the same time, the SMSG acknowledges that complexity can be a relevant condition when the ability of the financial instrument to fulfil the stated objectives of the investment product are not easy to understand for the retail investor, especially on a medium to long term horizon, as it bears on potential for mis-selling and a product not performing as it should.

110. Therefore, the SMSG would very much like ESMA to reduce this confusion on the issue of complexity. The SMSG acknowledges that complexity should remain one of the "*significant investor protection concern*" criteria and factors, and thus retain a relatively high level of priority, but rather in the sense of the complexity for the investor to be able to understand whether the investment product has the inherent capacity to fulfil its stated objectives as initially planned.

111. The SMSG also supports better defining the criterion currently ranked as number 10: "*probability, scale and nature of any detriment, including the amount of loss potentially suffered".*

112. Next to toxicity (the high probability of not achieving stated/advertised goals and/or of destroying the real value of savings), the number two criterion should be the magnitude of total charges and commissions borne by the client directly or indirectly, including disclosed and undisclosed charges, including the various layers of costs (for example in a unit-linked insurance contract). Ample evidence and research show that poor and below-expectation returns are often correlated to the level of charges and costs. Part of this criterion is captured by ESMA's Technical Advice proposal in criterion i. (b) (*multiple layers of costs and charges*) and iv (b) (*any hidden costs and charges*).

113. Also, in the proposed Technical Advice there is no definition at all of what is an "*investor protection concern*". There is also no definition of what is to be considered an investor "detriment", other than mentioning under ii. The size of the potential problem or detriment . "*..including the amount of loss potentially suffered..*" (TA 4. ii (d)). The SMSG believes that it is necessary to define these key notions, especially when one observes that investor concern and detriment are being not only mixed up but also confused with the quite different notions of "complexity", "innovation", "leverage" and "risk".

114. Financial health product intervention (just as is the case for physical health products) should concentrate first and foremost on toxic products. Toxic investment products are the ones where the ex ante probability of achieving either the stated investment objective and/or a real positive return is low. Evidence and research show that the manufacturer and the distributor are most often aware of these probabilities although they are almost never disclosed to the clients. For example, a retail equity "index" fund" that actually underperforms its index benchmark by thousands of basis points after only a few years, and is therefore very likely to deliver a negative real return over the mid and long term is certainly a toxic product that should disclose a clear warning and not be promoted to as an "index" tracking fund to individuals.

ESMA product intervention

115. As mentioned in the Consultation Paper, MiFIR provides intervention powers for ESMA and EBA (Art. 40 and 41 MiFIR) as well as for NCAs (Art. 42 MiFIR). ESMA is of the opinion that these powers "complement the existing empowerments for sanctions and other measures" (para 5 – page 167 of the Consultation paper). "Considering the overall legal conditions" and the "principle of proportionality", the powers "should in general be limited" (para 8 – page 167 of the Consultation paper). However, this analysis does not sufficiently describe the scope and function of the intervention powers.

116. Art. 40 (1) MiFIR entitles ESMA to prohibit or restrict the marketing, distribution or sale of financial instruments. According to Art 40 (2) MiFIR, ESMA shall take a decision only if all of the following conditions are fulfilled:

(a) the proposed action addresses a significant investor protection concern or a threat to the orderly functioning and integrity of markets or to the stability of the financial system

(b) regulatory requirements under Union law that are applicable to the relevant financial instrument or activity do not address the threat

(c) a competent authority has not taken action (...).

117. Art. 42 (1) MiFIR provides a similar competence for NCAs. The prerequisites laid down in Art 42 (2) MiFIR are generally the same as is in Art 40 (2) MiFIR. But there is one important difference in the level 1-text (underlined in the text below):

> *NCAs shall take a decision if all of the following conditions are fulfilled:*
>
> *…*
>
> *(b) existing regulatory requirements under Union law applicable to the relevant financial instrument or activity <u>do not sufficiently</u> address the risks ….*

118. Thus, it follows from the wording of the respective provisions that ESMA's intervention powers are pretty narrow compared to the intervention powers of NCAs. ESMA may only take action if Union law *does not address* the threat. ESMA has competences only in exceptional cases – an interpretation which is in line with the intention of the legislative bodies (cf. recital 29 MiFIR: In "exceptional cases, ESMA or EBA should be able to impose a prohibition or restriction").

119. ESMA is right in pointing out that the intervention powers have to be interpreted with regard to the requirements laid down in Art 40 (2) and 42 (2) MiFIR. The SMSG fully agrees with ESMA's interpretation that the powers should be seen in the context of the new product governance principles (cf. Art 16 (3) and 24 (2) MiFID-II). But there are other – more important – rules under Union law which address threats and risks for investors and for the stability of financial markets and it would have been extremely important to mention them in the Consultation Paper.

120. Investor protection is mainly ensured by the duties Member States have to introduce for investment firms. These provisions have been modernized and can now be found in Art 24 (general principles and information to clients) and Art 25 MiFID II (assessment of suitability and appropriateness and reporting to clients). In particular, investment firms are obliged to recommend to the clients the investment services and financial instruments that are suitable for them and are in accordance with their risk tolerance and ability to bear losses.

121. An important regime dealing with threats for the stability of financial markets is the Short Selling Regulation (SSR), which, in addition, also protects investors, cf. Recital 2 SSR).

122. Therefore, the SMSG would like to highlight that ESMA may only take action if none of these (and of course other) regimes tackle the threats. Nonetheless, the bar for NCAs is also very high. NCAs shall take action if the above mentioned requirements (i) do not sufficiently address the risks and (ii) the issue would not be better addressed by improved supervision or enforcement of existing requirements. This means that NCAs first have to evaluate whether the existing regime sufficiently deals with investor protection concerns. Since Union law is still based on the idea that investors are protected by information/disclosure obligations it is hardly conceivable that NCAs come to the conclusion Union law does not sufficiently deal with threats and risks for investors. Even if the answer were to be yes, NCAs first have to use their (under MiFID-II harmonised) supervisory tools and sanctioning measures in order to tackle the threats and risks. It follows from the two-fold test that NCA's intervention powers are not a complementing measure (as described by ESMA in its Consultation Paper) but a mere subsidiary instrument.

123. However, some members of the SMSG are of a different view and consider that the deterrent dynamic of these powers is potentially significant and to have this useful effect, the product interven-

tion power needs to be characterized as a complementary and operational (albeit certainly radical in nature) power which can be activated when necessary.

Intervention powers and use of the term "consumer" instead of "client" or "investor"

124. The SMSG notes that ESMA understands the intervention powers as an instrument of consumer protection (cf. para 6 page 167 "ESMA is therefore of the view that flexibility is required, both to be able to intervene in relation to new instruments that may not meet given criteria, or conversely not necessarily intervene if given criteria are met but overall consumer detriment or disorderly functioning of markets is not foreseen or detected. » and No 3 Technical Advice: "consumer protection prerequisite"). However, the level 1-text does not mention the term "consumer" but rather uses the concept of "client" and "investor". In some Member States, the terms "consumer" and "client resp. investor" reflect different philosophies about the need and intensity of protection.

125. Since level 1 establishes intervention powers for the protection of "clients" (cf. Recital 29 and Art. 40 (8) (a) MiFIR) resp. "investors" (cf. Art. 40 (2) (a), (3) (a), (8) and Art. 42 (2) (a) and (c), (7) MiFIR) the SMSG recommends that the Technical advice do not describe the powers as an instrument of consumer protection.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 8 August 2014

Jesper Lau Hansen
Chair
Securities and Markets Stakeholder Group