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Retail investors' challenges: what investor protection safeguards should accompany increased retail participation in capital markets?

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Ladies and Gentlemen,

Good morning. I am delighted to have been invited by Assogestioni to give this keynote address and I would like to thank the organisers for giving me this opportunity. This session's theme – what European strategy for retail investors – is at the heart of ESMA priorities. It relates to one of our core objectives: investor protection.

The European Commission has announced its intention to publish a Retail Investor Strategy in the first half of 2022. At ESMA, we very much welcome this initiative and in that context are glad to contribute to efforts to support retail participation in our capital markets while ensuring individual investors benefit from appropriate safeguards and protection.

Increased household participation is a positive and welcome trend for the development of European capital markets. Recent figures have shown an increase in retail participation driven by a range of factors, including innovation. Digitalisation is transforming the way in which retail investors can access investment products. New online and mobile trading platforms offer convenient, easy-to-use investment services. We are also seeing a growing demand for sustainable investment products. However, we, as regulators, and many of you, as market participants, know, such an increased participation may only be sustainable if an adequate level of protection of retail investors is ensured to preserve trust in the financial system.

The investment management industry has a key role to play to offer products that respond to the savings needs of European households and provide relevant information for investors to make informed investment decisions.

Against this background, I would like to focus my intervention on three areas. I will first focus on the costs and performances of investment funds, and then move to the issues related to the distribution of retail investment products and related disclosures. Finally, I will touch upon the specific challenges from an investor protection perspective of the growing demand for products marketed as *sustainable* or deemed to incorporate Environmental, Social and Governance (ESG) factors.

The impact of costs on investors' participation

The total cost of a fund (among other products) is a key aspect to take into account when considering retail investors' participation in capital markets.

Let me share with you a few takeaways from our last ESMA Annual Statistical Report on performance and costs of EU Retail Investment Products[1]. It shows the impact of costs on the final return to investors and highlights the high heterogeneity of fees charged across UCITS funds.

First of all, unsurprisingly the report shows that retail investors are subject to higher costs compared to institutional investors.

The report also shows the difference that exists between active and passive funds. For equity funds, actively managed funds outperformed in gross terms passively managed fund[2] for a ten-year investment. However, this outperformance is not sufficient to compensate the higher costs of actively managed funds, leading them to underperform passive funds on a net basis. Similar differences can be observed for a three-year investment in bond funds. All these findings are overall consistent with those in past iterations of the report.

Looking specifically at ESG funds, interestingly, our preliminary analysis shows that total costs of ESG equity UCITS funds were slightly lower than their non-ESG peers in 2019. ESG equity funds also performed better over the same period, with an annual gross performance of 12% compared to 10.8% for non ESG equity funds[3].

These results show the crucial role of costs when assessing the outcome of retail investments. It also underscores the importance of making clear and comparable information available to investors.

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[1] esma_50-165-1710_asr_performance_and_costs_of_eu_retail_investment_products.pdf (europa.eu)
[2] Passive funds excluding ETFs.
[3] Excluding ETFs.

Beyond this analytical work, ESMA has identified a lack of supervisory convergence on the way the notion of *undue costs* charged by funds managers that lies in European legislation is interpreted across the EU. Of course, we fully recognise that, on the one hand, pressure on asset managers is high in a low-for-long interest rate environment which exacerbates the search for yield and, on the other hand, National Competent Authorities' (NCAs) action is often limited due the lack of a competition mandate. Hence, supervision may be particularly difficult in this area. Nevertheless since costs represent a significant drain on funds' performances (especially for retail investors), this needs to be addressed first and foremost in the interest of the investors themselves, but also to create a virtuous circle and support their further participation in capital markets.

Against this background, costs and performance of retail investment products was identified as one of the Union Strategic Supervisory Priorities (USSP) which NCAs should focus their supervisory action upon in 2021.

More specifically, we are currently coordinating a Common Supervisory Action on costs and fees in UCITS funds across Europe, to assess the compliance of supervised entities with a number of provisions in the UCITS framework, including the obligation of not charging investors undue costs. At the beginning of next year we will analyse the results of the NCAs' supervisory efforts and are hopeful that this exercise can contribute to greater convergence and focus on investor outcomes.

Rethinking retail distribution

Investment products should not only to bear fair costs, but should also be appropriately distributed, in particular when it comes to retail investors.

The Commission has expressed concerns that retail investors are not sufficiently benefiting from the investment opportunities that the capital markets can offer and has tasked ESMA with providing advice on how to enhance and improve investor engagement.

This issue obviously may have many different angles. One could discuss for example the review of the European Long Term Investment Fund regulation and how such investment vehicles could enable retail investors to access the value embedded in less liquid assets, while ensuring appropriate protection through mitigation mechanisms to address liquidity and maturity transformation.

But at the end of July, ESMA has been asked in particular to assist the Commission in the preparation of its upcoming strategy for retail investments which I was referring to earlier. In fulfilling its mandate, ESMA will first of all look at the disclosures, and more specifically the possibilities offered by innovative forms of digital disclosures, to help ensure that investors receive the vital information they need to make informed choices but are not overloaded with overly complex data and documents. ESMA will also assess risks and opportunities stemming from the digital tools increasingly made available to retail client by online trading platforms and robo advisors. Finally, we will look at the phenomenon of ‘open finance’, with the sharing of investor data amongst investment firms and third party providers, and how it could bring benefits to consumers by enhancing competition and allowing new services to develop on the market while taking risks of data sharing duly into consideration.

The digital distribution of investment products is likely to become for many investors, and in particular younger retail investors, the main way to access financial markets in the years to come. ESMA has a responsibility in addressing risks and concerns in a timely manner and helping ensure that the rules protect these often inexperienced investors from inappropriate practices. For example, in light of the increasing use of online distribution models where firms charge no explicit commissions for the execution of client orders but often receive payment for order flow from third parties, ESMA recently made clear its strong concerns and, within the limits permitted by the current MiFID legislation, issued a warning about the risks stemming from the use of such practices and has asked NCAs to prioritise this topic in their supervisory activities.

On all these aspects of digital distribution, ESMA plans to publish a call for evidence to gather information which may contribute to shape the policy advice that will be shared with the Commission and looks forward to receiving valuable contributions and views.

I would like to also touch on the topic of inducements, noting that their broad use raises the concern, already identified by the EU co-legislators when drafting MiFID II, that such practices could potentially result in biased advice and poor asset allocation.

When advising the Commission on this important topic in March 2020, ESMA encouraged the Commission to conduct further analysis to assess the impact the MiFID II inducements regime has had on the distribution of retail investment products across the Union and the impact that a ban would have on different distribution models. In the meantime, ESMA has taken action on the basis of existing requirements by making clearer its position on the application of some key obligations on inducements with the objective to promote further convergence among firms and supervisors.

The Commission is currently using the opportunity of the MiFID II review to make such an assessment. At ESMA, we welcome this development and look forward to the progress that can be made on this key investor protection topic.

Disclosure challenges in an ESG era

Another major development of the last few years has been the extraordinary growth of sustainable finance in Europe. Growing investor appetite, climate-focused public policies and pressure from civil society have led to the development of a growing number of ESG products.

The total value of assets managed by funds with ESG strategies domiciled in the EU has increased by 20% during the first half of 2021. And, the outstanding amount of green and social bonds from EU issuers has grown 40% over the same period.

Furthermore, you may see from our latest Trends Risks and Vulnerabilities Report published earlier this month[4] that 90 new EU ESG ETFs have launched in 2020, exceeding the number of new non-ESG ETFs (62).

Europe plays a leading role in this space, and we hope strengthened disclosure requirements embedded in the sustainable finance disclosure regulation (SFDR), in application since 10 March 2021, will enhance

[4] https://www.esma.europa.eu/sites/default/files/library/esma50-165-1842_trv2-2021.pdf

investor confidence and further support market growth.

Moving forward, financial market participants and financial advisers are required to disclose comprehensive sustainability information on their websites and in their products' pre-contractual and periodic reports.

ESMA – together with EBA and EIOPA – have delivered one set of technical rules underpinning the regulation in February and are working hard on a second set of rules related to the taxonomy-specific products disclosures. The latter will improve transparency for those products wishing to market themselves as making investments in taxonomy-compliant activities.

A key challenge however in developing the detailed product disclosures has been to attain comparability of disclosures across the very different underlying documents prescribed by SFDR. At one extreme, the pan-European pension product (PEPP), has SFDR pre-contractual sustainability disclosures in the four-five page long key information document (KID). At the other extreme, a UCITS fund has those same disclosures in its prospectus, which can run to hundreds of pages.

The ESAs have attempted to strike a balance between comparability and the need to reduce complexity. In order to ensure that all investors are able to understand the disclosures, the information included in the templates provided by the ESAs have to be clear and concise, in plain language and easy to read.

We are conscious of the limitation of the legislation: for instance, it is undeniable that Article 8 of the SFDR (which relates to products promoting environmental or social characteristics) is designed to capture a very broad and heterogeneous set of financial products, allowing a broad spectrum of sustainability strategies with differing levels of intensity within that category. This could make investor understanding of different types of products and strategies challenging or worse lead to greenwashing.

Given the soaring demand for ESG products and the massive move from investment managers to green their product range, the risk of greenwashing is actually very high.

Preliminary analysis of fund prospectuses shows very different approaches to financial product classification under the SFDR. For investment funds, the share of funds classified as products with sustainability characteristics or objectives under SFDR varies greatly by country of domicile, ranging between 7% and 77%.

Therefore, working to prevent greenwashing will be a priority for ESMA. We will work with NCAs to further our understanding, share experiences, and identify ways to enhance supervisory convergence, and effective means to limit the risk of greenwashing. This is a very challenging task, but clearly essential to build up confidence in these products, especially for retail investors.

Conclusion

Ladies and gentlemen, let me conclude by saying that for ESMA ensuring a safe framework for individual investors to invest in financial products is a core priority. We are deploying resources in an effort to build trust in the financial system by ensuring investors are treated fairly and properly informed on the products in which they invest.

Lower costs, a sound distribution architecture which takes into account technological developments and fair disclosure of information (in particular when it comes to sustainability) are necessary ingredients to support investors’ trust and participation in financial markets.

I hope that we – supervisors and market participants – can work together to promote sound retail participation in capital markets.

Thank you for your attention.