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THE COMMISSION RELEASES ITS STRATEGY FOR RETAIL INVESTMENTS IN EUROPE

On 24 May 2023, the European Commission published its long awaited legislative proposal on the EU Retail Investment Strategy. The proposal, which consists in a single omnibus Directive that would amend several directives (MiFID II, IDD, AIFMD and UCITS), aims - as part of the Capital Markets Union flagship project - to put capital markets at the service of people, offering increased investment opportunities and strengthening retail investor protection rules.

Thus, the Commission pursues several objectives with this reform: the further harmonization of requirements across distribution channels (e.g. insurance or direct distribution) is meant to i) empower retail investors, ensuring that they take more informed investment decisions that better correspond to their needs and objectives, (ii) encourage improved and fairer market outcomes and ultimately, grow retail investor participation in capital markets.

While there have been previous attempts to harmonise regulatory requirements across the different types of distribution channels (e.g. securities, investment funds, life insurance), this is the first comprehensive initiative where the European Commission aims to amend organizational and conduct requirements for financial actors across the board, in an effort to define rules that are aligned and coherent across all relevant legal instruments.

In its EU Retail Investment Strategy, the Commission notably proposes to allow authorities to control the price of financial products and of investment services, rewrite entirely the rulebook for commissions, and significantly amends both client onboarding processes and cost disclosures.

It should be noteworthy that from the onset, the Commission intended to pursue an ambitious approach for this EU Retail Investment Strategy. Among the topics to be addressed, one key item relates to the issue of how to deal with inducements. This has triggered an intense debate, among policy-makers, as well as with Member States and the financial services industry.

In this context, whereas a full ban of inducements with respect to advice may have been envisaged for a time by the Commission, such a restrictive measure is not retained in the proposal published yesterday, seemingly in the face of strong policy, financial and legal concerns (although it must be noted that it is not excluded a potential ban on inducements may be contemplated at a later stage).

That being said and in any case, its proposal is not any less ambitious, as the European Commission proposes a significant overhaul of the entire inducements framework and reinforcement of conduct requirements for investment firms and entities in scope that provide investment advice.

The Commission legislative proposal includes also a number of other suggestions, ranging from the certification of employees, to financial education materials, to supervisory powers granted with respect to online platforms, and marketing. The proposal addresses also requirements on financial guarantees and professional insurance with respect to insurance intermediaries. This newsletter does not touch upon all those measures in detail, so as to focus on core issues given their importance, namely product governance (**1.**), commissions/inducements (**2.**), costs and charges (**3.**), and client onboarding (**4.**), to highlight the main takeaways and potential impacts of this proposal.

1. FROM "PRODUCT GOVERNANCE" TO "COST GOVERNANCE"?

Targeted amendments to MiFID II, IDD, AIFMD and UCITS.

The European Commission proposes to amend product governance requirements set out both under MiFID II and IDD by amending the relevant Level 1 texts and to introduce new provisions (a new Article 16-a in MiFID II and a new Article 25 in IDD).

The proposal would require manufacturers and distributors to ensure that "*only products that deliver Value for Money are offered to retail investors*" by adopting a pricing process for packaged retail and insurance-based investment products distributed to retail clients ("PRIIPs"). The Value for Money test will be composed by:

(1) The identification and quantification of costs: t

a. costs and charges related to the PRIIP would need to be identified and quantified by the manufacturer; and

b. costs of distribution or other costs and charges not taken into account by the manufacturer would need to be identified by the distributor.

(2) **The assessment of the costs against internal (subjective) and external (objective) criteria**: each regulated entity would then need to ensure that it offers Value for Money to the target market, including when compared to other products on the market:

a. Internally, the manufacturer and distributor each would need to make an assessment of each PRIIP to determine whether the costs of the PRIIP and, for distributors, of the service, are "*justified and proportionate, having regard to the characteristics, objectives and, if relevant, strategy of the* [*financial instrument / product*]*, and its performance*";[1]

b. Externally, this pricing assessment would be undertaken against a benchmark to be established by ESMA or EIOPA, as the case may be (setting out total product costs, as well as comparing different cost components or distribution components). The authorities would establish the benchmark on the basis of reports provided by manufacturers and distributors.

A deviation from the relevant benchmark would "*introduce a presumption that costs and charges are too high, and that the product will not deliver Value for Money*"([2]), i.e. the manufacturer / distributor will have to conduct additional testing to assess whether the costs and charges are justified and proportionate and, if this cannot be demonstrated, the manufacturer shall not approve the product and the distributor shall not offer or recommend it to a retail client.

The methodology for the benchmark, as well as the criteria to determine whether costs and charges are justified and proportionate, would be set out in Level 2 texts under the Commission proposal.

In addition, MiFID II manufacturers would also be required to integrate marketing communications and marketing practices in the distribution strategy set out as part of the target market (by proposing an amended version of Article 24(2) of MiFID II). This would entail significant changes, as the European MiFID Template (currently used by the industry across the EU) does not include information on marketing practices or communications.

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[1] Insurance product manufacturers must also assess the risk of misunderstanding the features, costs and risks of the insurance-based investment product by customers.

[2] As indicated in the explanatory memorandum of the European Commission proposal.

Moreover, the European Commission proposes to amend AIFMD and UCITS so as to introduce a requirement for asset management companies to establish a pricing process as well. This process should ensure that:

- the costs borne by AIFs/UCITS or its unit-holders are duly identified and quantified;
- the costs borne by AIFs/UCITS or unitholders are not undue: a given cost is "due" if (i) it is in line with disclosures in the prospectus or fund documents and KID / KIID, (ii) it is "*necessary for the [AIF/UCITS] to operate in line with its investment strategy and objective or to fulfil regulatory requirements*" and (iii) it is borne by investors in a way that ensures fair treatment of investors;
- the costs borne by the retail investors are justified and proportionate in light of the characteristics of the AIF/UCITS (including the investment objective, strategy, expected returns, level of risks and other relevant characteristics). This must be assessed on an annual basis by the alternative fund managers / management companies and must also take into account the relevant benchmark of ESMA. Similarly, in case of deviation, the alternative fund manager / management company must perform additional testing and accept any deviation only where it is duly justified and proportionate. Otherwise, the management company / alternative fund manager must not market the investment fund to retail investors.

  If undue costs have been charged to the AIF / UCITS and to investors, the management company must reimburse the investors and must report to the competent authorities, the depositary and the auditors of the fund.

This proposal on undue costs also follows the publication by the ESMA on 17 May 2023 of its opinion on undue costs of UCITS and AIFs.

The Commission proposal envisages the adoption of a Level 2 measure in order to determine the minimum requirements with respect to pricing process of AIFs and UCITS.

2. THE STAGED APPROACH TO INDUCEMENTS

Targeted amendments to MiFID II and IDD.

The European Commission proposes to amend to a significant extent the inducement framework by introducing a dedicated provision in the Level 1 texts.[3] The Commission has estimated that the quality enhancement test is insufficient and should no longer be required. Rather than opting for a ban on all forms of inducements - which would have entailed significant and sudden impacts, the Commission proposes an entirely new regime, the requirements of which will vary depending on the type of service(s) provided.

Investment / insurance service	Suggested inducements framework
Common amendments for MiFID II and IDD	
Investment advice / Insurance advice	The Commission proposal maintains the possibility for investment / insurance advisors to provide non-independent advice and receive inducements. However, firstly, there is a greater alignment between MiFID II and IDD, notably since

[3] Articles 24 and 24a of MiFID II and Articles 29a and 29b of IDD.

Investment / insurance service	**Suggested inducements framework**
	the intermediary will have to inform the policy holder whether the advice is provided on an independent basis or not. If the intermediary receives inducements for the provision of advice, it will have to inform the client that the advice is not independent. In addition, investment / insurance advisors will need to: - provide advice on the basis of an assessment of an appropriate range of financial instruments / insurance-based investment products and, where applicable, underlying investment asset; - **recommend "*the most cost-efficient*"** financial instrument / insurance based investment product and, where applicable, underlying investment asset, among products identified as suitable to the client; and - recommend, among the range of products identified as suitable, **"*a product or products without additional features that are not necessary to the achievement of the client's investment objectives and that give rise to extra costs*"**. Finally, in that case, the advisor will need to ensure that the reception of the inducement does not impair compliance with its duty to act in accordance with the best interest of the client and must inform the existence, nature and amount of such payment to the client. The advisor will **no longer need to comply with the quality enhancement test**.
Distribution on a non-advised basis	With respect to distribution of financial instruments, the Commission proposal would prohibit firms from providing or receiving any payment in connection with RTO or order execution services "*to or from any third-party responsible for the creation, development, issuance and/or design of any financial instrument on which the firm provides such execution or reception and transmission services*". The European Commission has introduced limited exceptions in respect to this prohibition : - if the investment firm provides advice on a non-independent basis relating to "*one or more transactions of that client covered by that advice*" ([4]). - If the "inducement" consists in the payment of a fee by an issuer to an underwriter or a firm providing placing services, which firm would also provide RTO or execution services to a retail client, with respect to simple products that are not PRIIPS ; or In these cases, the revised standard regime would apply. With respect to distribution of insurance products, the Commission proposal would prohibit insurance intermediaries or undertakings manufacturing insurance-based investment products or distributing such products on a non-advised basis from paying or receiving inducements (with limited exceptions). **In short, the European Commission proposal would either require distributors to (i) distribute financial instrument's / insurance contracts to retail clients only on an advised basis (by providing investment / insurance advice) or (ii) to switch their current remuneration model from an inducement model to a fee-based**

[4] The Commission expressly clarifies in its explanatory memorandum that the exemption provided in Article 24a aims to cover cases where "*investment advice may be combined with the services of execution of orders and reception and transmission of orders, with the main service being investment advice.*"

Investment / insurance service	**Suggested inducements framework**
	model.
MiFID II specific amendments	
Portfolio Management	**MiFID II firms would be prohibited from receiving <u>and paying</u> any inducements to third parties with respect to portfolio management.** Such an amendment may significantly impact structures whereby portfolio managers provide their services from a MiFID II firm.
Other investment services	When providing other investment or ancillary services, a firm would be authorised to pay or receive inducements, provided that (i) the inducement does not impair compliance with the duty to act honestly, fairly and professionally and (ii) the inducement is disclosed to the client. **In particular, firms would no longer have to justify the provision of an additional or higher quality service to the client.**
Research	The European Commission proposes to extend the exemption from requirements in relation to the financing of research. By way of context, MiFID II Quick Fix allows MiFID II firms to pay for research by invoicing a commission upon the execution of an order that covers both the execution of that order and the payment of research, regarding research on issuers whose capitalisation does not exceed EUR 1 billion. The Commission proposes to increase this threshold to EUR 10 billion.

3. A REINFORCEMENT OF THE REQUIREMENTS RELATED TO COSTS AND CHARGES

Targeted amendments to MiFID II and IDD.

The Commission proposal aims to integrate the current requirements on costs and charges in the Level 1 texts.

3.1 *Ex ante* disclosures requirements on costs and charges

The Commission does not expressly indicate that it seeks to amend the regime for costs and charges disclosure on an *ex ante* basis. That being said, the comparison between the currently applicable and the proposed texts does raise questions.

The amendments with respect to *ex ante* costs and charges may impact the determination of costs to be disclosed and their method of calculation. As a consequence, this may imply a full review of costs for all products currently in distribution and a review of the current industry standards.

Topic	Article 24 MiFID II and Article 50 DR 2017/565 ; Article 29 of IDD	Article 24b of MiFID II and Article 29 of IDD under the Commission Proposal
Common amendments for MiFID II and IDD		
Content of disclosure	Firms must disclose all costs, including (a) service costs, (b) product costs, (c) third party payments received by the firm.	For investment firms Firms must disclose all explicit **and implicit** costs, including (a) service costs, (b) product costs, (c) **any inducements paid or received** and (d) **how the client may pay for them**. For insurance distributors Firms must disclose information on all explicit and implicit costs, third-party payments, including all costs and charges relating to the distribution of the product and how the client may pay for it.
Presentation of costs	The aggregated costs and charges must be expressed both as a cash amount and as a percentage.	The overall cost must be expressed in monetary terms and **percentages calculated up to:** - **for financial instruments,** the maturity date of the financial instrument or for financial instruments without a maturity date, the expected holding period recommended by the firm, or in the absence thereof, holding periods of 1, 3 and 5 years; - **for insurance-based investment products,** the term of the product.
Inducements	Costs and charges rules require firms only to disclose the amount of the inducements received.	Firms will need to disclose the amount of the inducements, as well as **the cumulative impact of such payment on the net return over the holding period** and their "**purpose**".
MiFID II specific amendments		
Full-disclosure regime vs. simplified disclosure regime	MiFID II establishes two regimes with respect to cost disclosure. If a firm recommends or markets financial instruments, or has to provide a KID or KIID to the investor, the firm has to disclose both product and service costs, as well as inducements (full regime disclosure). Otherwise, the firm may only provide service costs, as well as inducements (simplified disclosure regime).	**No distinction between full-disclosure regime and partial-disclosure regime.**

Topic	Article 24 MiFID II and Article 50 DR 2017/565 ; Article 29 of IDD	Article 24b of MiFID II and Article 29 of IDD under the Commission Proposal
Exemptions	Articles 29a and 30 of MiFID II currently exempt firms from complying with costs and charges requirements when providing services to professional clients (except in case of investment advice or portfolio management services) or to eligible counterparties. This was in particular a modification brought about by MiFID II Quick Fix.	The Commission seems to require firms to comply with costs and charges requirements when providing services to eligible counterparties. [5] This may, however, be inadvertent, since the Commission has not suggested amendments to Article 29a of MiFID II with respect to professional clients.

3.2 New *ex post* disclosure requirements on costs and charges

Under the current regime, under MiFID II, firms must provide *ex post* information on costs and charges on the financial instrument and on the services where (i) the full-disclosure regime applies, i.e. where they have recommended or marketed the financial instruments or where they have provided the client with a KID/KIID and (ii) there is an ongoing client relationship. Under IDD however, firms only need to provide information on costs on a regular basis.

The Commission proposes to put in place specific types of reports to be provided to a retail client depending on the type of service provided.

Service	Content of report
MiFID II: Investment services and custody services	The report will need to include: (i) all implicit and explicit costs and charges, including service costs, product costs and inducements; (ii) dividends or interests perceived, (iii) taxes borne by the client and (iv) valuation and net performance of each financial instrument and of the portfolio.
MiFID II: Investment services without custody services	The report will need to only include all implicit and explicit costs and charges. However, it will apply in all cases (e.g. even if there is no active marketing or provision of services to KIID / KID products).
MiFID II: Custody without investment services	The report will need to include only (i) the implicit and explicit costs borne by the client, (ii) the dividends perceived, (iii) the taxes owed and (iv) the market value of the financial instrument.
IDD: Manufacturers of insurance-based investment products	The annual statement would notably need to include: (i) the total costs and charges, (ii) the annual performance of each underlying asset and the global performance of the portfolio, (iii) the taxes owed, (iv) the market or estimated value of the underlying investment assets, (v) the payments by the policyholders, (vi) the projections of expected outcome at the end of the contractual / recommended holding period and (vii) information on early termination of the investment.

[5] In addition, we note that Article 24b of MiFID II reintegrates in Level 1 the possibility to limit the application of costs and charges requirements, which is currently set out in Article 50(1) of Delegated Regulation 2017/565.

These reports will only have to be provided to retail clients and will need to include a breakdown of all costs and third party payments per year, as well as on a compounded basis since the start of the relationship.

4. THE REVISED CLIENT ONBOARDING PROCESS

In addition to the above , the Commission also proposes to revise the client onboarding process by amending requirements on client categorisation, as well as the content of the appropriateness test and of the suitability test.

4.1 Suitability and appropriateness tests

Targeted amendments to MiFID II and IDD.

Suitability. The amendments to the suitability test aim to ensure that investment / insurance advisors or portfolio managers will also need to assess portfolio diversification.

Appropriateness. The amendments for the appropriateness test are more significant**.**

For retail clients, the appropriateness test will include questions on the capacity to bear full or partial losses and risk tolerance.

This proposal echoes a previous proposal by the European Commission (not adopted), which was to abolish the distinction between the suitability test and the appropriateness test and to carry out a single test for all clients.

If the firm considers that a transaction is not appropriate for a client, it must not proceed with the transaction, unless the client asks to proceed despite such warning.

In practice, this would not only require firms to carry out anew all appropriateness tests, but it would also place firms providing RTO / execution services or that distribute insurance products in a "semi-advisory" role even where they do not provide advice (since firms will need to request information on the financial situation of the client and his/her risk tolerance and will need to be able to warn that person if the product does not match his/her financial situation and risk tolerance).

This should not affect, however, appropriateness tests carried out for professional clients. In respect of such clientele, firm can continue to assume that the professional client has the necessary experience and knowledge and not assess their financial capacity to suffer losses or their risk tolerance as part of the appropriateness test.
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4.2 Client categorisation

Targeted amendments to MiFID II.

Most of the conduct requirements set out above apply only for products distributed to retail investors. At the same time, the Commission proposes to amend client categorisation requirements to make it easier for clients to be treated as professional clients.

The Commission proposal makes it easier to opt-up non professional clients so that they can be treated as elective professional clients:

- the criterion with respect to the client portfolio is reduced from EUR 500K to EUR 250K and is assessed as an average over the previous 3 years;

- the criterion with respect to experience has been amended to also cover clients who have "*undertaken capital market activities requiring to buy and sell financial instruments and/or to manage a portfolio of financial instruments*" (encompassing for instance financial directors of industrial companies); and

- a new (fourth) criterion is added with respect to clients with "*a recognised education or training that evidences his/her understanding of the relevant transactions or services envisaged and his/her ability to evaluate adequately the risks*."

For legal entities, they will also have to justify that they satisfy at least two of the following criteria: a balance sheet criterion of EUR 10 million, a net turnover criterion of EUR 20 million, and the own funds criterion of EUR 1 million. The legal representative of the entity or the person responsible for the investment transactions on its behalf shall also be assessed.

5. NEXT STEPS

The EU Retail Investment Strategy is a legislative proposal by the European Commission which falls under the ordinary legislative procedure. As such, it will be now examined and amended by both the Council and the European Parliament, with the latter facing upcoming elections in June 2024.

The Strategy will also require the adoption of a number of Level 2 texts for the more technical details, such as the methodology for the product benchmark to be published by the European authorities or the format to provide cost disclosures to retail clients. Therefore, the full picture of the impact and implications of the EU Retail Investment Strategy will take time to materialise.

More importantly, and beside the uncertainties inherent to any legislative process, the EU Retail Investment Strategy raises a number of legal questions, notably given the restrictions to financial market participants' freedom to conduct business and repercussions on competition in the markets concerned.

The Commission proposal underlines that a full ban would have had hard-to-predict consequences, all while acknowledging the potential for "*significant and sudden impacts on existing distribution systems*". It is not obvious why the main measures envisaged - which in some cases would *de facto* amount to a quasi-ban - would be any less disruptive.

In this context, although a Strategy that aims to growing retail investor participation in EU capital markets should be welcome, significant concerns remain about the means envisaged by the Strategy. In the meanwhile, in other financial markets such as the United Kingdom, initiatives are being contemplated to simplify retail disclosure regimes and better preserve the freedom of choice of retail investors.

Ultimately, will the measures proposed achieve the objective of increasing the level of participation by retail investors in financial markets in the EU, or will it achieve little change in retail participation at the cost of damaging the business model of many firms? The question (of the proportionality of the EU Retail Investment Strategy) still remains.

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