Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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Commissioner Jonathan Hill
DG FISMA
European Commission
B-1000 Brussels
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18 March 2015

Dear Commissioner Hill,

Position of the Financial Services Consumer Panel on ESMA's technical advice under MiFID 2

I am writing to you on behalf of the UK's Financial Services Consumer Panel to set out its position on the European Securities and Markets Authority's (ESMA) technical advice regarding the level-2 measures for the second Markets in Financial Instruments Directive (MiFID 2).

The Panel provides advice and challenge to the UK's Financial Conduct Authority (FCA) on the extent to which the FCA's general policies and practices are consistent with its general duties. The Panel represents the interests of all groups of financial services consumers and operates independently of the FCA. The emphasis of its work is on activities that are regulated by the FCA, although it may also look at the impact on consumers of activities that are not regulated but are related to the FCA's general duties.

Accordingly, the Panel takes a keen interest in the protection of retail investors, and has followed the negotiations surrounding MiFID 2 closely. It is broadly supportive of the approach recommended by ESMA on these aspects, and we hope that the Commission will only deviate from ESMA's technical advice where necessary to strengthen investor protection further.

Overall, MiFID 2 could deliver significant and tangible benefits for consumers across the UK and it is vital that the overall consumer-friendly approach formulated by ESMA is maintained in the Commission's delegated acts. The Panel's position on the key elements of MiFID 2 and ESMA's advice is set out in more detail below, focused on the following:

- **Information on costs and charges;**
- **Inducements and research;**
- **Non-advised sales of complex products;**
- **Product governance**;
- **The choice of legal instrument.**

Information on costs and charges

The Directive stipulates that information about all costs and charges in connection with the investment service and the financial instrument must be "aggregated to allow the client to understand the overall cost as well as the cumulative effect on return of the investment". The Panel strongly supports comprehensive disclosure of investment costs.

At present, poor disclosure, weak governance and multiple conflicts of interest mean that competition in the investment market is not working in the best interests of consumers.

ESMA has recommended disclosure that includes one-off and on-going costs, including transaction costs and performance fees. While this is a positive step, more work may be required to determine whether ESMA's list truly reflects all costs and charges attributed to retail investment funds and therefore paid by retail investors. For example, firms may seek to apply the 'waterbed effect' and shelter costs outside of the disclosure requirement, for example through fiduciary management and blending fees.

However, ESMA's proposals will be a significant improvement, making it clear that transaction fees should be properly disclosed. The Panel is supportive of EMSA's argument that the Directive's exemption from disclosure for costs triggered by underlying risk "should be understood narrowly" and encompasses only "movements in the value of capital invested caused directly by movements in the value of underlying assets". We agree that transaction costs should not be considered caused by underlying market risk, even where these are embedded in the bid-ask spread.

As regards transaction costs, the Panel recognises concerns about the misalignment between MiFID 2 and the fifth UCITS Directive. UCITS management companies are not currently required to disclose transaction costs, meaning that investment firms which are unable to obtain information on such costs from UCITS MCs voluntarily may not be in a position to meet their disclosure requirements to their customers under MiFID 2.

While this is not a satisfactory situation, it should not be allowed to provide investment firms with a pretext to claim it was impossible to disclose transaction costs. Investment firms should liaise with UCITS management companies proactively to obtain the required information. However, any future revision of the UCITS Directive should bring the UCITS disclosure requirements in line with MiFID 2.

We also believe that any future review of cost disclosure should include serious consideration of the introduction of a single and comprehensive annual charge. Crucially, all other costs, currently deducted by the investment manager directly from the fund, would be borne by the investment management firm. This would enable consumers to compare different firms' charges, and also act as a powerful incentive on firms to improve efficiency. Without a fundamental alignment of incentives, the industry is always likely to find ways around even the most prescriptive forms of regulation.

Inducements and research

ESMA in its technical advice proposes to create an exhaustive list of acceptable minor non-monetary benefits; any inducement received by an independent adviser or portfolio manager not included on this list would constitute a breach of MiFID 2. We support this approach, which goes a long way to tackling the conflicts of interest inherent in any business model where the intermediary is partially or wholly financially dependent on the manufacturer.

ESMA has also maintained its initial recommendation to classify research as an inducement, but now also advises the Commission to "clarify the conditions under which

the receipt of research does not qualify as an inducement". In 2012, the UK's Financial Services Authority (FSA) found that few firms exercised the same vigilance in their expenditure on research and execution services – costs deducted directly from the value of funds under management and therefore hidden from view to investors – as they exercised over payments made from the firms' own resources.

Accordingly, ideally research should in principle be paid for by the firm itself, and research should not normally be categorised as a 'minor non-monetary benefit'.

ESMA proposes that a ring-fenced research account, managed by an investment firm, be funded by a specific research charge (or paid for by the firm itself). As ESMA recognises, the success of this proposal as a means to unbundle research and trading activity rests on the requirement that the research charge should "not be linked to the volume and/or value of transactions executed on behalf of the clients." It adds that "future ESMA guidelines may also be useful in this area".

The Panel considers that this proposal is subject to an obvious weakness: how would regulators know whether the price charged for the research by an integrated research supplier, that also offered execution and other services, was not implicitly related to the level of trading undertaken by the investment firm with that supplier?

Investment banks, in particular, may under-price research under this proposal to favour their major investment firm clients. Such banks may well do so in order to generate trades which afford a number of different revenue streams: commissions on equity trades; market making profits across all securities and foreign exchange; proprietary trading profits enhanced by the information provided by higher order flow; advisory fees from corporate clients whose company stocks were artfully promoted by captive company analysts within the investment banks.

To mitigate the danger and to strengthen the ring-fence, steps would need to be taken to ensure that research was properly priced and not implicitly related to trading activity. Of a number of possible partial solutions, integrated suppliers of research and execution services could be requited publicly to post prices for research packages in a manner that, in practice, did not discriminate between different classes of client. This solution would not prevent general under-pricing, however.

The Panel strongly supports ESMA's aim of tackling conflicts of interest generated by inducements, and the restrictions it proposes on how research can be paid for are a useful starting point which should not be watered down further. However, we would urge the Commission take into to consideration the concerns outlined above, which could undermine the new, more stringent restrictions on research. The Panel believes that more radical unbundling solutions warrant consideration in the future.

The "quality enhancement" test for inducements

In its final technical advice, ESMA removed an earlier proposal that an inducement could never be seen as "quality enhancing" if it is used to pay for goods or services that are essential to the firms ordinary course of business.

The final ESMA advice appears to make it possible for firms to accept commission as "quality enhancing" if they provide the client with access to a wider range of products combined with "added-value tools" such as "objective online information tools" or providing "periodic reports of the performance and costs and charges associated with the financial instrument".

The Panel is concerned that ESMA in its final advice appears to have set the bar for what constitutes 'quality enhancing' too low. In particular, its final technical advice may in effect create a 'safe harbour' provision for the industry to make the quality enhancement criterion perfunctory only.

To give article 24(9) the full effect intended by the EU legislature, firms should be required to justify to its customers on a case-by-case basis how the quality of the service was enhanced by the inducement.

Non-advised sales of complex products

The Panel understands that certain parts of the asset management industry have argued that the purpose of Article 25(4)(a) of the Directive is only to identify certain instruments as being automatically 'non-complex'.

In the Panel's view, the wording of the Directive makes it sufficiently clear which products are always to be considered 'complex' (including structured products and derivatives). We support the Commission's interpretation that products listed as 'complex' in MiFID 2 itself should not be tested again for complexity under the level-2 measures.

Product governance

MiFID 2 requires both manufacturers and distributors to observe certain product oversight and governance arrangements. In particular, financial instruments must meet the needs of an identified target market, the strategy for distribution of the instruments must be compatible with this target market, and the investment firm must take reasonable steps to ensure that the financial instrument is distributed accordingly.

The Panel welcomes the fact that ESMA's proposals should provide more clarity between providers and distributors around where responsibility lies should something go wrong, as firms working together will be required to agree their respective responsibilities. Demographic information about the customer and contextual information around the sale would be particularly useful.

Any information which manufacturers obtain, or which distributors can provide to the manufacturer, about actual experience with the product should help it to tailor existing and future products more effectively to the consumer. If it appears that the product is being sold outside the original target market, distributors should make this information available to the manufacturer and both should consider whether sales of the product should be suspended, or whether it may have been mis-sold. The manufacturer should also be required to inform the regulator.

Legal instrument

The Panel understands the Commission is still considering whether the level-2 measures will take the form of a Directive or a Regulation.

Implementing EU legislation through Regulation does provide for better consistency and hopefully better understanding of standards. However, we consider that the value in this approach is greater for wholesale markets rather than retail markets, where the general understanding of regulations is already low and further complicated by the different cultural approaches to and expectations of investor protection standards. Therefore, we would encourage the Commission to implement the level-2 measures through a

Directive, which would allow national competent authorities to better tailor the requirements to their local retail investors.

The Panel would also be concerned if the use of a Regulation restricted national regulators' abilities to provide additional helpful guidance or supporting information to their firms and consumers about certain types of requirements and expected standards of behaviour and conduct – including, for example, in relation to particular domestic sectors or in relation to particular domestic products. Currently, national regulators can respond to such needs where they have implemented Directive requirements in their own rulebooks; we would be concerned if the situation were different because requirements were directly applicable through a Regulation.

In particular, the use of a Regulation could have the unintended consequence of reducing investor protection measures already in place in the UK where these go beyond the requirements of the future delegated act. A Regulation as the legal instrument could jeopardise the UK's current regime for safeguarding client assets when an investment firm becomes insolvent, because UK rules are significantly more developed than what would be required by the ESMA technical advice.

In this regard, we recall that article 16(11) also permits Member States to impose requirements that are 'additional to' both the level-1 Directive and any level-2 measures.

I have copied this letter to Maria-Teresa Fabregas-Fernandez in DG FISMA's Securities Markets Unit. If the Panel can be of any further assistance, please do not hesitate to contact me.

Yours sincerely,

Sue Lewis
Chair
Financial Services Consumer Panel