

## MiFID II+ ESMA recommendations for the improvement of investor protection



The European Securities and Markets Authority (ESMA) has advised the European Commission (EC) on aspects regarding retail investor protection, related but not limited to transparency. While it was “encouraged to see that digital trends and new business models are contributing to making investing more accessible to the general public”, ESMA says there are risks attached and action is required to prevent a weakening of investor protection. We asked Spectrum Market’s Chief Regulatory Officer, Alpay Soytürk, about these risks.

### MiFID II<sup>1</sup> is widely considered one of the heaviest pieces of financial market legislation ever introduced. Why did ESMA put forward proposals on better investor protection, aren’t the existing rules strict enough?

The proposals ESMA has made are a response to the EC’s calls for advice to all European Supervisory Authorities on retail investor protection. The EC’s 2020 Capital Markets Union Action Plan aimed, in part, to ensure that retail investors will be able to take full advantage of capital markets and that there are coherent rules across legal instruments. In particular, this would include adequate protection, bias-free advice and fair treatment, open markets with a variety of competitive and cost-efficient financial services and products, and transparent, comparable and understandable product information. And yes, the EC has been concerned that retail investor participation in capital markets remains very low when compared to other economies and that investors are not sufficiently benefiting from the investment opportunities that the capital markets can offer.

### What was the concrete mandate that ESMA was assigned by the EC regarding these issues?

ESMA was asked to identify substantial overlaps, gaps, redundancies and inconsistencies across investor protection legislation that could have an adverse effect in that they cause confusion or impede decision-making. But more important than the question of how the different legal frameworks are complementary or overlapping and how to address any such issues, has been assessing whether the existing rules really support retail investors in well-informed investment decision-making.

### Do they?

In the supervisory evidence ESMA has collected from national competent authorities, it cites a survey of 3,800 retail clients conducted by the German BaFin<sup>2</sup>. According to the survey, while many investors were in favour of the new rules, more than half of them said that they wouldn’t use the additional information that became available as a result of the introduction of MiFID II. Other observations by the French AMF<sup>3</sup> showed that relevant disclosure is being provided too late in the customer onboarding or product sales process when the potential investor has already been overwhelmed with other details. The supervisory authorities’ research shows that more information does not automatically constitute better information.

### Can you please give an example?

According to article 25 of MiFID II, firms must establish a record that includes the documents agreed with the client stipulating the rights and obligations of the parties and the terms on which firms offer their services to the client. While MiFID II theoretically allows inclusion of such details by reference to other documents or legal texts, firms overload their clients with all that information in paper format. This is because they are afraid that if they miss out any contractual detail, they could be held liable if there is a dispute. It’s quite common that clients, when for example receiving investment advice with product completion, take home 80 or more pages of paper. These include statutory company information and key data, product descriptions, costs and charges information, performance and scenario analyses, risk warnings, conflicts of interest policies and much more.

You will hardly find that volume of contractual or contract-related information hand-outs in any area other than investment and insurance products and services. It has become evident that most clients cannot digest this amount of information in a way that would lead to more informed, more balanced investment decisions. The effect is detrimental in that the information becomes confusing. By the way, this produces a large environmental impact that the EU is otherwise trying to curb.

### Are you saying all this information is in fact not relevant?

I think that each single component is relevant. But it’s worth considering whether it is necessary to print all these documents and to hand them over combined with the marketing material accompanying the product. In the field of in-person investment advice, some firms have started collecting the client’s email-address as a mandatory item during onboarding and then automatically sending the documents in their entirety as an email-link.

However, moving processes into digital environments still doesn’t get to the heart of things. Think how often you’re asked to give your consent to cookies or to confirm a company’s online terms and conditions (which may change very frequently and require a re-confirmation each time). The truth is that most people don’t read texts such as software licenses as they think they understand the inherent risks. That’s the critical point. While the regulator seeks to protect the retail investor, investment firms sometimes seek to cover themselves against legal claims and the retail investor skips reading all the information provided. The portion of this information that addresses key risk, performance or cost aspects the investor should definitely understand is getting lost in the shuffle.

### How could this be solved?

I think there’s hardly a chance to influence the amount of contractual information being provided by investment firms to their clients. However, ESMA recommends, for example to layer different kinds of information with the first layer containing key or “vital” information facilitating the identification of key characteristics of financial products very quickly.

### Like in the PRIIPs<sup>4</sup> key information document (KID) that already exists?

Yes, although the vital information disclosure is supposed to be even more condensed than the KID. The problem is that, in most cases, the service relationship between the investment firm and the client goes beyond execution and entails the entirety of the contractual and organisational disclosure discussed. That’s where the KID – which, in principle, is a very good example of an at-a-glance overview of the risks, costs and return potential attached to a product – easily gets under recognised.

### Does “in principle” mean it’s actually not serving the purpose it was designed for?

It depends on how it is made available, as discussed, and how it is designed. We provide a KID for each securitised derivative although Spectrum Markets is neither the manufacturer nor the distributor of the securities. If you look at these KIDs, you’ll quickly realise that the risk warnings are very prominent and, I would say, impossible to overlook or to misinterpret. The information on the associated costs and the scenarios is clear and concise. That said, whereas the risk categorisation for securitised derivatives is straightforward ‘high risk’ and the target market is similarly easy to define for one product, many firms define target markets for clusters of products where this is not really appropriate. However, the appropriateness of the product governance guidelines under MiFID II is part of another review exercise that ESMA is currently consulting on.

Thank you very much!

<sup>1</sup> Directive 2014/65/EU, the “Markets in Financial Instruments Directive”

<sup>2</sup> Bundesanstalt für Finanzdienstleistungsaufsicht

<sup>3</sup> Autorité des marchés financiers

<sup>4</sup> Packaged Retail and Insurance-based Investment Products

today to discuss how the seamless market access that our venue provides, can help to grow your retail client business.

Please don’t hesitate to get in touch if you wish to receive further detail.

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