ESMA's Final Report on the European Commission mandate on certain aspects relating to retail investor protection. International Bulletin, June 2022.

On 27 July 2021, ESMA received a mandate from the European Commission (EC) requesting technical advice on certain aspects relating to retail investor protection. This request falls within the framework of the Retail Investment Strategy that this European institution is preparing, and which it plans to publish in the coming months, one of the main objectives already announced being to put consumers at the centre of this policy in order to offer them adequate protection to stimulate their participation in the capital markets, which is key to the development of a Capital Markets Union.

On 29 April, ESMA sent its Technical Advice to the EC with specific proposals which basically aim to ensure that investors receive the key information they need to help them make well-founded investment decisions and protect them from aggressive marketing practices. The main topics covered in this report are as follows: (a) disclosure obligations, (b) digital disclosure obligations and (c) digital tools and channels. For its preparation, the opinions of interested parties were gathered by means of a public consultation (open from 1 October 2021 to 2 January 2022).

Specifically, the document reviews certain aspects of the disclosure obligations included in the Markets in Financial Instruments Directive (MiFID II) that could work better, or that require adjustments in the digital field, while also analysing the impact that new technologies are having on the financial markets and that leading to the appearance of new practices, such as those known by the names of gamification or payment for order flow (PFOF), and the intervention of new subjects such as "finfluencers".

DISCLOSURE OBLIGATIONS

In this section, ESMA responds to the mandate received from the EC (1) to assess whether there are inconsistencies or gaps in the European regulations governing disclosure obligations that might hamper retail investors' ability to make well-founded investment decisions. and (2) to give its views on what should be considered vital information.

In its response, ESMA makes the following proposals relating to disclosure obligations:

(1) *Machine readability and durable medium*. First of all, ESMA recommends a revision of MiFID II in order to require that the documentation addressed to retail clients be machine-readable.
Regarding the medium for mandatory disclosures, it is appropriate to recall that the Capital Markets Recovery Package, adopted in response to the crisis generated by the COVID-19 pandemic, made electronic communication the default option as opposed to paper, following ESMA's advice. Following another recommendation contained in the aforementioned advice, ESMA again proposes to the EC in this document that it should not be necessary for entities to deliver their best execution and conflict of interest policies to their clients in paper format, provided that they are available on their websites.

(2) *Standardised format for disclosure of information*. ESMA proposes to the EC that MiFID II be amended with the aim of receiving a mandate allowing it to develop a European format for information relating to costs and charges.

(3) *Marketing communications*. ESMA recognises that this matter, from a regulatory point of view, is not sufficiently developed, which is why, first of all, it proposes to the EC to introduce a definition of commercial communications that includes online advertising. This concept must include private messages sent by third parties (influencers, for example) or if they involve personal recommendations, they must be subject to the regulations on financial advice.
Secondly, it proposes amending Article 69 of MiFID II regarding the supervisory powers of NCAs to make it clear that they may act against deceptive marketing practices and even extend this power to ESMA when appropriate.

Lastly, ESMA proposes requesting the EC to include in MiFID II an express mandate entrusting it with the development of guidelines on this matter.
In addition, ESMA considers it appropriate to specify the supervisory expectations for which, in its opinion, at least the following aspects should be taken into account: (a) the compliance function of the entities should carry out mandatory controls on the content of these communications and submit a periodic report on this matter to the management bodies; (b) entity checks should include verifying that marketing communications are actually distributed as approved; (c) the internal controls on this matter should be documented and (d) the entities should keep records that include, for example, 'posts' by third parties on the network paid through non-monetary compensation by the entity. In addition, the document indicates that the entity's management body should define and monitor its marketing policy.

(4) *Vital information*. ESMA agrees with the EC's perception that retail customers are currently receiving an excess of information (which is often not read). For this reason, it proposes the development of minimum basic information (vital information) to be included in advertising communications (even if they are short messages posted on social media), and in other documents, and that can be reviewed by the client with 'at a glance'. In its opinion, the approach should be transversal, after consumer testing, and cover, at least, (a) characteristics and objectives of the products, (b) risks and (c) costs and fees.

(5) *Alignment of cost disclosures between MiFID II and PRIIPs*. ESMA considers that the fundamental objective to be pursued in this area should be the alignment of the regimes described in MiFID II and the Regulation on key information documents for packaged retail investment and insurance products (the PRIIPs Regulation), opting, in fact, for reflecting in the former regulation the amendments introduced in the recent level 2 revision of the latter (that is, in its Delegated Regulation).
Consequently, it proposes that the EC reflect the following aspects in MiFID II, after testing consumers: (1) First of all, for financial products with holding periods equal to or less than one year, the net return should be considered to be zero. If the holding period of the financial product is longer, information on the costs must also be provided (bearing in mind that in PRIIPs a return based on the moderate scenario is taken as a reference in these cases); (2) in relation to the calculation of the transaction costs, it is proposed to amend the MiFID II Delegated Regulation II to reflect the slippage methodology as used for PRIIPs. The recent level 2 revision of PRIIPs used this methodology, which implies the aggregation of transactions, with the aim of eliminating the impact of market fluctuations from the calculation (previously the calculation was distorted by the difference between the execution price and the price existing when sending the order to the market (bid-ask spread)). Additionally, when the number of transactions is limited, as is often the case when it comes to the provision of services, it is proposed to follow the simplified methodology contained in Annex VI of the PRIIPs Delegated Regulation; and (3) in relation to the calculation of indirect costs, such as performance fees, the historical data of the last five years should be taken as the basis for their calculation.

DIGITAL DISCLOSURES

In this section, ESMA responds to the mandate received from the EC to assess whether it is necessary to adapt the disclosure obligations contained in the European regulations to the digital support/format.

In its response, ESMA begins by recalling that the general principles contained in MiFID II, in terms of investor protection, are applicable regardless of the communication channel used (that is, even if it is digital).
The two basic principles referred to in the document are (1) the obligation of investment firms to act honestly, impartially and professionally, in the best interest of their clients, when providing investment and ancillary services and (2) the obligation of investment firms to provide impartial, clear and non-misleading information.

However, it recognises that given the constant evolution of new technologies, it is not necessary to make specific amendments to level 1 or 2 of the European regulations, but it is necessary to issue guidelines on how to comply with the disclosure obligations in digital format or medium, or how firms should use digital tools or techniques, at level 3, for which it requests the EC to include a specific mandate in MiFID II in this regard. It also acknowledges that some adjustment may need to be made at level 2 in parallel with what is achieved at level 3.

In particular, ESMA highlights the following aspects to be developed at level 3:

Disclosure obligations in digital format/medium

(1) *Easy navigability of information*. Entities must present the information in a structured and visible manner. The document also expresses its support for the technique of layering and proposes that the first layer should correspond to the vital information mentioned above.

(2) *Retrievability and possibility to save information*. The key information provided digitally must be capable of being saved, at any time, in a downloadable file.

(3) *Presentation and format*. The information to be provided must be adapted to the device used, in such a way, for example, that the font size is legible and that it does not require too much scrolling.

(4) *Versioning*. Firms must keep a copy of all the versions that have been made available to clients. In addition, these will be sorted by date and number in order to make it easier for customers, or potential customers, to access the version on which they have based their decision.

(5) *Limiting security risks for clients*. Entities must mitigate the possible security risks that may affect their clients as well as ensuring that the data obtained from them is sufficiently protected.

(6) *Use of different means to communicate*. The means of communication used by firms must be appropriate based on the complexity of the products. For example, the use of chat bots by entities should not limit the possibility of contacting the entity directly.

(7) *Social media and influencers*. The document highlights the obligation that entities must have to verify that the information published by influencers complies with the regulations, in particular whether they receive any type of compensation or incentive from them (in which case, the incentive regime will be applicable). It also points out that if they are personalised recommendations they may constitute financial advice.

Risk warnings

ESMA recommends that the EC include in MiFID II the legal basis for it, or the competent national authorities (NCAs) to be able to require firms to include in their advertising communications (even if it is done through the social media), and other mandatory information, risk warnings in the case of complex or risky products.

In addition, ESMA recommends that entities monitor whether the design and presentation of information is effective for customers. It also proposes that the regulations or guidelines issued in the future cover any form of interaction, whether direct or indirect, of entities with clients, such as, for example, through the use of influencers or any person external to the entity, including possible future developments such as the 'metaverse'.

The document also refers to the recent phenomenon known as gamification, which uses techniques that simplify complex information, or make the investment process easier, by adding games or game-like competitive elements to financial services and thus potentially pushing clients to invest at undue risk. ESMA recognises that the use of these techniques forms part of firms' distribution strategies and, consequently, they must be subject to the general principles of investor protection and the regulations on product governance (and must be consistent with the identified target market, for example). Furthermore, it announces its intention to address this issue in its current review of the guidelines on product governance requirements.

DIGITAL TOOLS AND CHANNELS

In this section, ESMA responds to the mandate received from the EC to assess the risks and opportunities that digital tools and channels represent for retail investors, including the issue of open finance.

In its response, ESMA addresses the following issues:

(1) *Robo-advisers*. ESMA does not consider it necessary, for the moment, to amend the regulations to regulate specific aspects of this phenomenon since it is a business model that has not yet been sufficiently developed in the European Union (EU), without prejudice to continuing to monitor its evolution. Furthermore, the document highlights that some aspects have already been taken into account in the updating of the guidelines regarding the assessment of suitability.

(2) *Payment for order flow* (PFOF). This is a business model in which brokers receive payments from third parties for directing client orders to them for execution.
ESMA already pointed out in its July 2021 Statement that this practice could hardly be considered compatible with MiFID II, in particular with the rules relating to conflicts of interest, incentives and best execution.
In this document, ESMA recommends that the EC complete its regulatory proposal contained in the review of MiFIR (Regulation on markets in financial instruments), in order to include the prohibition of this practice not only in MiFIR but also in the provisions of the Directive (MiFID II).
The EC proposal is currently under negotiation between the co-legislators and has been heavily criticised by those who believe that there is not enough evidence of the harm this practice can cause to retail investors to ban it

outright. However, ESMA, after the analysis carried out, supports its prohibition, in particular due to the proven negative impact on the quality of the execution.
Additionally, the document deals with the business model called “zero-commission brokerage”, which does not necessarily have to be based on the PFOF practice. ESMA recalls that in these cases it is necessary for entities to provide, ex ante and ex post, complete information on the costs applicable to the financial instruments and services. It also announces that it will monitor the different sources of income of the entities that follow this business model, such as securities lending, in case it is necessary to reinforce investor protection requirements.

(3) *Open finance*. The EC announced in 2020 its goal of having a complete framework in this area by 2024. In this advice, ESMA recommends that the EC take into account all the potential risks and benefits that it may imply for the securities market sector and offers to monitor the development of its legal framework.

The EC, as it has already announced, will take into account this advice from ESMA, among others, in the preparation of its Retail Investment Strategy.

Useful link:

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