SwissFinanceCouncil
Fostering International Dialogue

SFC Position on EU Retail Investment Strategy

The Swiss Finance Council (SFC) engages in dialogue around policy developments in finance at a European level. Our members, including among the largest global asset and wealth management firms, have substantial activities within the EU and contribute to a diverse market and choice for European retail investors.

We have an interest in the EU Retail Investment Strategy (RIS) because our members operate as both retail investment product manufacturers and distributors, serving EU clients from both within the EU and on a cross-border basis. This position paper sets out our views on the proposed EU Retail Investment Strategy and focuses on the proposals affecting the client categorisation, the diversity of product offerings and the distribution mechanisms, which are key issues for Swiss firms. This paper outlines our initial views. As legislative discussions progress, we will follow up with detailed suggestions and proposals.

1. Best interest test: Recommend products offering the most value to the client

The requirement in the proposed best interest test for financial advice to recommend products without additional features that are not necessary to the achievement of client's investment objectives should be deleted. These additional features might include a financial product with a certain investment strategy which implies higher costs, a capital guarantee, or structured products with hedging elements. Each of these elements can provide value to a client depending on their circumstances and their needs, and should not be penalised during the advice process.

Moreover, it would go against the fiduciary duty of investment advisor to for example include passive funds such as ETFs in the offer when an active fund is advised. This would place a disproportionate focus on cost and would not consider the circumstances of the customer and whether such a product would potentially offer them greater value. This would in fact be contrary to the clients' best interest, whereas the investment advisor is already bound to recommend the most cost-efficient product from the range of suitable products.

It is also unclear how the proposed best interest for financial advice should interact with existing suitability and appropriateness tests. Any overlap risks reducing the overall quality of advice.

2. Inducements: Clarify scope of execution-only products and assess impact of full package of proposed measures on retail investor outcomes

Non-independent investment advice, for example within the context of existing client banking relationships, remains the prevalent form of distribution in the majority of EU Member States. Therefore, any proposed changes must be carefully assessed so as not to cause unnecessary disruption to retail investors. In this context, we support the decision not to ban inducements outright and instead assess the impact of the proposed changes, such as greater transparency around inducements including its impact on the cost and performance of retail investment products, as part of the review clause.

We believe that the proposed execution-only ban is too extensive. Retail banking clients often make use of a combination of execution-only and advisory services. It is, therefore, key to clarify the scope of execution-only products to avoid a complete ban of legitimate third-party payments for example in the scenario where a client initially invests through advice, and later on wants to invest more in the same products on their own. Switching between advised and execution-only services may not be possible under the proposals, to the detriment of the investor.

The Retail Investment Package is made up of connected measures, which taken together, aim to improve how products are produced, disclosed and sold. However, the proposal to review whether to ban all inducements after three years, based on a narrow assessment of the effect of the proposals, risks making a highly consequential policy decision, based on an incomplete view of the retail investment landscape. Moreover, three years is not a sufficient amount of time to consider the proposals given that a lag can be expected between new processes and products being introduced and a measurable effect on investor outcomes. We strongly recommend that all of the measures are reviewed in combination after 5 years, once they have had sufficient time to bed in and retail outcomes can be accurately measured.

3. Inducements for portfolio management: Maintain existing inducement regime

Under MiFID II, portfolio managers are prohibited from accepting and "retaining" inducements. This means that inducements can be received but only if they are passed onto clients. The RIS modifies this by prohibiting portfolio managers from paying and "receiving" inducements.

Under the current model there is no conflict of interest or detriment to the investor, since the inducement paid by the manufacturer to the portfolio manager must be passed onto the investor. A full ban, as proposed, would mean portfolio managers would have a reduced choice of inducement-free investments to offer to their clients. Fund managers in turn would need to offer new inducement free share classes, in addition to existing share classes, if they wish portfolio managers to continue to invest. Each additional clean share class incurs new costs for example, the PRIIPs KIDs, fund documentation and reporting. It also prohibits the payment by the portfolio manager of services that may be necessary for the provision of portfolio management along the value chain (e.g. payments to third parties for IT, research or support services to the client).

Since the current approach provides tangible benefit to investors in the form of choice and improved pricing, we consider the proposed change to be detrimental. It is also at odds with the RIS's wider ambition to target the payment of inducements for "non-advised" sales, which are clearly separate from portfolio management. We strongly encourage policymakers to reinstate the current wording regarding the prohibition of "accepting and retaining" inducements with the obligation to pass them.

4. Value for Money: Establish a holistic value assessment for manufacturers and distributors

We support robust product governance rules to ensure that retail investment products offer value for money to retail investors. However, the proposed approach which focuses on the cost of a product is too narrow and does not consider the value of different investment product components as relevant to the investment strategy and preferences of the retail investor.

The cost of a fund itself is defined by its strategy, portfolio composition and geographic focus. For example, European small and mid-size cap funds will tend to have higher ongoing charges than large-cap equity funds, whereas marketing costs are higher for cross-border funds than domestic funds. These differences are natural and can reflect the work and expertise needed to effectively manage certain types of investments and spreading assets among a range of different markets or strategies is an important part of building a diversified portfolio.

We are concerned that the proposed cost benchmarks may reduce product diversity, if investment products that deviate from the benchmark cannot be marketed to retail investors unless the manufacturer or distributor can demonstrate that costs and charges are nevertheless justified and proportionate. This may hamper investments in asset classes that require specialist knowledge and more active engagement. The latter may offer strong performance potential but inevitably come with

higher costs, such as European Long Term Investment Funds (ELTIFs) or European small and mid-size cap funds. The cost benchmarks may also threaten the development of innovative products, especially in many emerging investment areas that lack historical price data such as sustainability-related funds. It is also unclear how ESMA and EIOPA will construct fully representative pan-European cost benchmarks given the differences across markets, products, investment strategies, and investors.

Instead of the cost-focused proposal, we recommend a more holistic value assessment that looks at a broader range of factors that contribute to the value that an investor derives from a certain investment, such as performance, diversification, quality of service, economies of scale and costs. This approach would ensure that investors remain free to select how much they want to pay for a product with the onus on product manufacturers to demonstrate that products offer value and where a product is more expensive, it can be justified by additional features that are worth paying for. Separately, enhanced disclosure requirements will already inform retail investors about the cost and performance of various investment products.

5. Client categorisation: Clarify knowledge criteria to access professional client status

We agree that MiFID II can be overly protective for certain types of sophisticated clients who are classified by default as 'retail' under the current rules. We therefore support the proposal to make it easier for sophisticated clients to opt up to be treated as elective professionals and therefore obtain access to a larger product universe (e.g. AIFs including hedge funds and private equity funds) that is more suitable to their long-term investment goals.

In doing so, this has the potential to unlock an important pool of investments for European companies from investors with greater means and risk-bearing capacity. The decision on whether or not to opt up to professional client status would remain with the individual client, once they have made aware of the criteria and consequences.

We believe that a combination of wealth (i.e. ability to absorb losses) and knowledge criteria is key to ensure appropriate categorisation of clients. However, we welcome further clarifications to the knowledge criteria, in particular with respect to transaction frequency and experience, so that sophisticated high-net-worth clients can effectively opt up to be treated as elective professionals. We also recommend an adjustment of the trading history criteria for legal entities that takes into account their specificities. See Annex for proposed clarifications.

Annex – Recommendation for clarifications to client categorisation framework

We welcome further clarifications to the opt up criteria for professional clients, in particular with respect to transaction frequency and experience, so that the proposed changes fully deliver on the intended policy objective. We also recommend an adjustment to the criteria for trading history so that legal entities effectively have the choice to opt up to professional client status.

Transaction frequency

Under current MiFID II rules, clients who wish to be treated as professional on request must fulfil a minimum of two criteria. One of such criteria refers to transaction frequency and stipulates that a client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters.

The draft legislation does not propose any changes to the existing rules which is problematic. The existing criteria of having 'carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters' does not appropriately accommodate a sufficiently wide range of asset classes. This criteria would be difficult to fulfil when it comes to less liquid instruments such as corporate bonds and OTC-derivatives, at least in some local markets and longer-term assets such as private equity, infrastructure and European Long Term Investment Funds (ELTIFs) where investment is made much less frequently.

Recommendation: The requirement should be expanded to accommodate a wide range of asset classes which are representative in size and market over an adequate period of time (e.g., 3 years).

Experience, knowledge and expertise

The experience in the financial sector criterion is expanded by recognising the investor's record of capital market activities when buying and selling financial instruments. However, the proposed text states that investor must provide proof of 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. The concept of 'relevant transactions or services envisaged' is very restrictive and does not adequately consider the understanding in capital markets as a tool to evaluate the risks.

A focus on 'relevant transactions or services envisaged means' that we would that the clients would have to be classified against separate asset classes. This will result in clients having elective professional status for some asset classes but not for others based the requirement on the client to evidence understanding of 'relevant transactions or services envisaged'. This is not in line with the current practices of wealth management in which clients are not typically serviced on a transaction by transaction basis, rather on a holistic basis often not knowing at the outset what kind of transactions will be relevant or applicable for the client over the lifespan of the (long-term) relationship.

Recommendation: The text should be expanded as follows: 'the client can provide the firm with proof of a recognised education or training that evidences his/her understanding of the relevant transactions, or services envisaged or capital market activities and his/her ability to evaluate adequately the risks.

Legal entities

The draft legislation introduces the possibility for legal entities to qualify as professional on request. They must meet two of the following - balance sheet (€10m), net turnover (€20m), and own funds criteria (€1m). The investment firm will need to assess if the legal representative or person responsible for investments understands the relevant transactions or services envisaged, is capable of making

investment decisions in line with the legal entity's objectives, needs and financial capacity and is able to evaluate adequately the risks.'

This fails to consider that legal entities in particular NewCos, and Special Purpose Vehicles (SPVs) have no trading history and therefore unable to meet the requirements.

Recommendation: SPVs (and similar structures) that have sponsors which opt-up professional criteria, should also be classified as professional clients, therefore brought into scope of categories of clients who are considered to be professionals.