

CONSUMER PROTECTION ON INVESTMENT MARKETS

Position by the Federation of German Consumer Organisations regarding the MiFID II Review

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I. FINANCIAL CONSUMER PROTECTION IN THE EUROPEAN UNION

1. STATE OF AFFAIRS

Since the 2007 financial crisis, the European Union (EU) has moved to protect consumers from harmful business practices and disadvantageous market structure of retail financial markets. The Markets in Financial Instruments Directive II (MiFID II) is front and centre of these efforts.

The original MiFID predated the 2007 crisis and was replaced by its follow-up MiFID II, in 2018. MiFID II addresses several issues of consumer protection and market stability, some of them successfully.

However, one of the issues that remain largely unsolved is the inducement-based sale of financial products, and its consequences. The main issue with this practice is that inducements incentivize financial service providers to pursue personal gain by selling highly provisioned products at the expense of consumers. This is exacerbated by the fact that major financial decisions are rare from the perspective of most consumers, and the purchasing decision is therefore largely formed by any advice they receive. The combination of these factors leads to a salesforce, confusingly called “advisors”, convincing consumers to buy disproportionately expensive investment products.

vzbv’s umbrella organisation, BEUC, continues to show the cost of this exploitative market structure on consumers on its campaign page www.thepriceofbadadvice.eu

MiFID II tackles this problem in two ways: advice may be provided independently, which means inducements are without exception prohibited - or non-independently. To provide non-independent advice requires the advisor to disclose any inducements received. Even then, inducement based advice is only permissible “if inducements provide a better service to the consumer”. This is an exception, which has proven wide enough to cover the entire market. Asset-management, thankfully, may not be offered in an inducement-based form at all. The digitisation of this service, so-called “Robo-advice” brings its own set of problems though, a paper on those issues is available in the footnotes.¹

The extensive exemption from the theoretical ban on inducements means that in practice, almost all product sales happen in the shape of “non-independent advice”. Inside this legal niche, the idea is to let the systems of independent and non-independent advice compete against each other. This way the consumers – supposedly – get to decide what they want. To enable such competition, MiFID II increased the transparency on costs. Particularly the costs of services like advice and brokering need to be clarified, because they are used to be subsumed as a part of product costs.

Therefore, in the absence of an effective ban on commissions, the approach to consumer protection was diverted to establishing rigorous transparency. The idea was that if consumers were provided with all necessary information, in a condensed and comprehensible manner, they themselves would be able to judge conflicts of interest. This approach of informing consumers of conflicts of interest, hoping they may protect themselves, is fundamentally inferior to eliminating these conflicts of interest.

¹ <https://www.vzbv.de/pressemitteilung/robo-advice-digitale-geldanlage-muss-besser-werden>

The damage caused to consumer trust in the financial system through this exploitative market structure is concerning. The widespread frustration and outright anger, over the continued failure of retail financial markets and the personal financial losses many citizens suffer because of it, undermine trust in the European Union and its institutions.

2. SCOPE OF MIFID II AND OF THIS PAPER

MiFID II regulates who, and under what circumstances, may interact with financial instruments such as shares, bonds and funds. This encompasses so-called “market infrastructure” such as exchanges and OTC-Trading as well as services directed at consumers, such as advice, brokering and asset management. Therefore, investor protection is only a part of MiFID, but it is an important one. Besides this, MiFID is the EU-level source of almost all of the important legal definitions on financial markets (such as “what is a share”).

At its core, MiFID II is a fully harmonised Directive - with the notable exception of investor protection. As vzbv is a consumer organisation, this paper is concerned with the investor protection aspects of the Directive only. This paper will discuss merits and flaws of both MiFID II from a consumer perspective as well as the idiosyncrasies of the German transposition and their effect on consumers in Germany. The paper will conclude with a list of suggested changes to MiFID II, which would further enhance consumer protection and market function in the European Single Market for retail investment products.

II. WHAT MIFID II DOES FOR CONSUMERS

MiFID II, Article 24 demands that member states ensure:

“... that, when providing investment services or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients...”

To this end, it provides a plethora of interlocking mechanisms designed to prevent product providers or intermediaries from misleading consumer’s financial decisions for their own benefit.

1. SUITABILITY

A so-called “suitability test” is intended to secure that the recommendations of advisors and the strategies of managers are appropriate for the individual needs of consumers. Article 25 of the Directive outlines these requirements. To this end, MiFID II establishes criteria, which have to be checked against the consumer’s preferences at the exploration stage of providing a financial service. The advice given has to match consumer needs to appropriate products. This aspect of MiFID II is central to ensure that advice follows consumer interests, and it has proven itself an effective tool; even though room for improvement remains.

While article 25 of MiFID II does outline what information about a consumer an investment firm must acquire to provide advice, there remains significant leeway in interpreting whether or not an investment product matches the consumer’s needs. For example, it is common for consumers to receive the advice to buy very expensive products - frequently actively managed funds. These funds do not outperform their much cheaper alternatives of passive funds. The cost of a financial product is a key part of its quality though, because high cost counteract the investment purpose. In this way, advisors often steer consumers into buying inferior products. To fix this problem, the definition of

suitability must be extended to include product quality. Products, which are of inferior quality to other (e.g. because of high costs), readily available options, can never be suitable for consumers.

On top of this issue, the suitability requirements do not include concrete rules on meeting an appropriate level of risk diversification. Furthermore, consumers should pay down debts before buying investment products, because it is unlikely that the dividends of their investments could match the cost of ongoing debt, stated simply: consumers are not hedge funds and should therefore deleverage before investing. At present, the suitability requirements make no mention of this necessity.

2. PRODUCT GOVERNANCE

MiFID II Article 16 provides a requirement for investment firms, to determine a target audience for its products.

“The product approval process shall specify an identified target market of end clients within the relevant category of clients for each financial instrument and shall ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market.”

The investment firm must make this determination before it markets the product. This rule requires matching the risks of the product with the expected needs of the target audience. Consumers have individual needs, abilities and tastes but all of this happens before the individual suitability for a consumer is determined. Therefore, such target audience guesses will always be arbitrary.

Furthermore, the idea of this rule disregards the portfolio approach to investment. A product is not suitable or unsuitable by itself; rather the risk mixture of the entire investment must be suitable to the interest and ability of the consumer. As such, a portfolio including assets that would be unsuitable by themselves can be entirely sensible.

On the other hand, this approach to consumer protection misses the main cause of harm to consumers: Investors are harmed by being sold expensive products that perform poorly. The risk-appropriateness of a single product is barely relevant, if the product quality itself is unsuitable for distribution. Thus, harm to consumers stems mostly from actively being sold insufficiently diversified portfolios of underperforming products, rather than inappropriate assets.

While this approach is well intentioned, it does not contribute to consumer protection. In fact, it can preclude consumers from accessing assets that would be a fair complement to their portfolio because the product, by itself, would be too risky.

3. TRANSPARENCY

The opening chapter of this paper already stated this: *“The approach of informing consumers of conflicts of interest, hoping they may protect themselves, is fundamentally inferior to eliminating these conflicts of interest.”*

Transparency is a valuable tool in consumer protection; it just should not be misunderstood as a substitute for independent advice. On the contrary, transparency and independent advice are complementary approaches in helping consumers make good decisions. Either measure is better than not doing anything but they would be more effective than the sum of their parts, if combined.

Furthermore, investment products are credence goods, meaning that their quality cannot be assessed by consumers even after purchase - much like the quality of medical services for example. An adversarial approach, where consumers and salespeople both pursue their own self-interest is inapplicable to markets of this kind. Like in medicine or law, the solution to this structure is having professionals exclusively beholden to the interest of their customers. However, the transparency offered by the directive does help consumers – even under these circumstances.

MiFID II requires providers to inform their customers of the properties and costs of the products they sell. This information comes at two times: before the sale is concluded (ex-ante) and at regular intervals, once a year – to inform consumers about the costs their financial market activity has incurred in the past year (ex-post).

3.1 Ex-ante information

MiFID II has achieved a significant improvement in the transparency of costs, particularly the costs of services, which are mostly caused by inducements in the sale of products. In theory, the ex-ante information documents would allow consumers to realise these cost ahead of time and are therefore vital to making an informed decision. In practice this approach has proven less effective than had been hoped – at the time of sale, the salesforce take the dominant role in shaping consumers perception of products. The information is therefore less impactful than it could be in a market where inducements were not an issue. Still having this information on the cost of products and services is still vital.

Despite the benefits of this information regime, further improvements are possible. For example, the wording of information could be clarified in many cases. “Cost of service incurred by the Bank” should instead be called “Cost for advice/execution or management to be deducted from the Consumers investments”. Changes such as this one would allow consumers a greater chance to understand the information presented to them because it is phrased from their perspective rather than the financial institutes. It is therefore advisable, that the phrasing in all consumer information documents should be re-evaluated. These documents are addressed at consumers and should not sport corporate jargon or legal definitions. Instead, the meaning of the information must be expressed in a manner, which is comprehensible to laypeople in a stressful situation.

vzbv recommends behavioural testing with consumers to find out what wording will most likely be effective in conveying the information documents meaning.

3.2 Ex-post information

Ex-post information is an advancement in consumer protection, which was introduced through MiFID II and was first deployed in Germany in 2018. It offers several improvements to consumers:

- ❖ It allows people to review information without feeling a pressure to make a decision soon. The fact that this information is sent to them once a year for their review, can also lead to a greater awareness of their financial situation and decisions.
- ❖ It allows consumers to review actual data on their concrete investments, in a consolidated form, rather than projections and estimates.
- ❖ The costs listed in the ex-post information documents, should help consumers realise just how expensive some products and services are. Seeing a concrete sum of

money deducted from one's personal savings helps consumers optimise their investments.

All of this said, this measure is new, and its execution is far from perfect. For instance, the information provided to consumers by different investment firms is different in format, quality and extent. For example:

- ❖ Many providers do not state the percentage of cost an asset causes alongside the total amount in Euros. This is an issue because it makes it difficult to identify cost drivers in the portfolio. A large position in an ETF costing 0.5 percent per year may seem more expensive than a small position in an actively managed fund costing 2 percent per year. As an example of this: a 100.000 euro investment in the ETF above would cause 500 euro running cost per year, an investment of 10.000 euro in the more expensive Fund would incur only 200 euro in running cost. Without the percentage, the information may be misleading. Both the total and the percentage are vital information.
- ❖ Some information documents do not seem to list assets, which have caused no cost in the reporting period. Again, this makes it hard for consumers to understand which of their assets are expensive and which are not.
- ❖ Only few providers seem to list, who the beneficiary of inducements are. Consumers would have a much easier time understanding the inducement structures, if they saw who was paid out of their investments for which product and how much.

vzbv's member organisation, Stiftung Warentest (StiWa) raised all of this information. It did so by asking readers of its magazine to submit ex-post information documents, which they have received from their financial institutions.² There has been significant response to this request, which has allowed StiWa to review the differences in the documents provided to consumers by different providers. Furthermore, responses also showed that many consumers realised for the first time, the cost of their securities accounts or assets held. Unfortunately, the responses were gathered for internal analysis by StiWa and there is no formal study that can be made available at this time. However the National Competent Authorities (NCAs) should be able to verify this information easily.

III. CONTINUED ISSUES

1. RED TAPE AND BURDEN OF PROOF

According to the Directive, investment firms are required to provide consumers with a written statement on suitability when giving advice and selling products. These documents are important because they theoretically enable consumers to demonstrate failures in an advisors compliance to the consumer protection articles. This does not work in practice in Germany as will be outlined in the next point.

vzbv would like to note, that this requirement was not championed by consumer protection organisations. Rather, from a consumer perspective, it would be much more effective, to reverse the burden of proof in civil law cases for false advice. If investment firms were required to prove that they did the best they could in the consumer's interest, they would be free to document their own efforts in any way they find sufficient. At the

² Stiftung Warentest: Finanztest (8/2019)

same time, this would free consumers from trying to prove having received false advice based on a document provided by a professional counterparty, which is often a futile affair regardless of the underlying facts. Overall, the bureaucratic burden of documenting the sales process could be reduced significantly through a transfer of the burden of proof to the professional party and such a transfer should be undertaken regardless of whether products are sold via inducements or independent advice.

In the absence of such a change, it is important, that the statement of suitability explains, in an easily understandable manner, why a specific recommendation was made. This necessitates two changes:

- ❖ The statement must explain how any one particular product is suitable to a specific consumer, taking regard to the details of this consumer's preference as explored in the course of the suitability test.
- ❖ With an eye towards the requirement that an investment firm must act in the best interest of the consumer, the statement must also explain how this product is superior to alternatives, which it did not recommend. For example: if an actively managed fund with a 2 percent annual cost has been recommended, the statement should explain how this particular product is superior to an ETF from the consumer's perspective.

2. TRANSPOSITION INTO GERMAN LAW

The implementation of MiFID II in Germany has widened the exception from the ban of commissions. In Germany, a "widespread network of branch offices" is sufficient to qualify as an improvement in consumer advice.³ This addition allows most banks to sell investment products on an inducement basis without any further requirement to serve consumer interest. The scientific service of the Bundestag has published an assessment, which concludes that this implementation is in violation of European law.⁴

In another quirk of Germany's transposition of this directive, MiFID II is purely a body of public law by verdict of the Federal Court of Justice (BGH) - even though MiFID does not include such a definition in its text.⁵ This means that the Directive offers no standing for consumers to sue providers for violations of MiFID II standards in Germany.

In Germany, the changes mandated by MiFID II have been implemented in separate laws depending on the business model of the provider. Banks and Savings banks are subject to the Securities Trading Act. Firms, which only provide advice or distribution services, may do so subject to the Trade, Commerce and Industry regulation Act. At present, this means that these actors distribute financial instruments supervised by the Chamber of Commerce and Industry (IHK) rather than the Federal Financial Supervisory Authority (BaFin). While this is due to change, and supervision of advisors and distributors is likely to be transferred to BaFin, the issue remains that MiFID II rules are divergently implemented into German law for different actors.

3. FRAGMENTED REGULATION AT THE EU LEVEL

In a similar vein, the distribution of insurance based investment products is covered by the Insurance Distribution Directive (IDD). While this set of rules largely parallels MiFID

³ WpDVerOV §6 (2).

⁴ Gutachten des wissenschaftlichen Dienstes des Bundestages (WD 4 - 3000 - 035/17)

⁵ BGH Urteil

II, its wording is weaker in several places. To ensure equal consumer protection among all investments, and to avoid regulatory arbitrage, the European Commission should push for a change of IDD to make its consumer protection standard equivalent to that of MiFID.

Another issue is the lacking uniformity of information documents across investment product categories. vzbv therefore supports the unification of product information between PRIIPs and UCITS. The service cost transparency that MiFID II provides to consumers would be further enhanced if product costs were better comparable.

IV. NECESSARY CHANGES

Because this is the central issue causing untold harm to consumers and private pensions systems in the EU it bears being stated a third time: *The approach of informing consumers of conflicts of interest, hoping they may protect themselves, is fundamentally inferior to eliminating these conflicts of interest.*

Consumers cannot be expected to be able to understand and argue their interests in a market most of them barely understand against professionals with years of experience in sales who have opposing interests. Providing consumers with a stack of complex information and legal documents at the time of sale does little to alleviate this fundamental mismatch of power. Furthermore, the fact that investment products are credence goods necessitates professional help - exclusively beholden to consumer interest - for consumers on this market, as outlined above. A **total ban on commissions and kickbacks** in the distribution of financial products **would align the interests of advisors with those of consumers**, thus achieving the **only credible solution to this form of market failure**. Both the United Kingdom and the Netherlands have conclusively demonstrated that such a solution is not only possible but yields measurably better results for consumers and pensions systems.

These countries also struggle with the aftermath of the inducement-system. Consumer trust, once lost, takes years to earn again but it can be done, provided the predatory structure, in which retail financial products are currently sold, is ended.

As a side benefit, such a ban would require a much lesser bureaucratic burden on providers and consumers alike, than the extensive regulation required to justify the use of inducements.

With regard to the issues outlined above, vzbv encourages the following changes to the Markets in Financial Instruments Directive II:

1. BAN INDUCEMENTS

vzbv retains this position: a ban on commissions and kickbacks is an unavoidable step, if the endemic market failure on retail financial products in the EU, is ever to be resolved.

2. IMPROVE THE DEFINITION OF SUITABILITY

The rules regarding the exploration of consumer interests in the course of determining suitability need to be more specific about the actual benefits of the product for a con-

sumer. A key part of this benefit would be having a reasonably low level of costs weighing down the investment, seeing as this is a key component of product quality. An inferior product should never be regarded as suitable just because it matches a profile. These rules and their application by providers need to be made subject to regular review by NCAs.

Supplementing this approach, a review of MiFID II should open the door for level 2 and 3 regulation concerning these new minimum quality standards for investment products which are being distributed to consumers.

The same principle also applies to the suitability of asset management services.

3. STRIKE PRODUCT GOVERNANCE RULES

Since these rules provide no discernible improvement in the level of consumer protection and because this is a fundamental issue in their conception, vzbv is of the opinion that these rules should be struck from MiFID II in favour of effective standards in the suitability assessment. As a side benefit, this measure would reduce bureaucratic burdens.

4. END HARMFULL EXEMPTIONS ON GERMAN FINANCIAL MARKETS

The chapter on present issues on retail investment markets outlined several discrepancies between MiFID II and its transposition into German law. Because these deviations harm consumer interests, the protection of which is a core aim of MiFID II, the European Commission should review the implementation of its financial market rules in Germany with an eye towards standardising the regulatory framework on the common market.

5. STANDARDISE INFORMATION DOCUMENTS

As mentioned above, information is a necessary component in consumer protection, but it is insufficient by itself. Within the limitations of the transparency approach, the current implementation of the transparency regime is showing promise but is not yet the effective tool for cost transparency that it should be. The information provided comes in various formats and is of variable degrees of comprehensibility and comprehensiveness. To ensure that the tool of ex-post information is used to its greatest effect, the information should be standardised. This way, the rules could achieve two goals:

- ❖ The ex-post information would yield easier comparability between different providers. This aspect would be particularly helpful for experts and independent advisors. With easily comparable information documents, it would be much simpler to assess the status quo of both the market and the individual consumer's situation. This, in turn, would enable independent advisors to steer consumers into better contracts. Consumers who receive more than one information document, because they have more than one securities account with different providers, would be enabled to easily compare the information received.
- ❖ By standardising the ex-post information documents, the regulator could be enabled to prescribe all necessary information to be included.

The standardised ex-post information document should certainly include all of the information that is currently mandatory. In addition, a statement of these costs, in percent as well as euro and cent (absolute numbers), should be a mandatory component in the cost-information.

The above suggestions are also valid for changes in the Ex-Ante information documents, for the same reasons. The only difference between these attempts at informing consumers should be the depth of information offered. In Ex-Ante situations, concise information is the dominant concern; in Ex-Post situations comprehensiveness takes the front seat. Both forms of information must keep an eye on remaining comprehensible to consumers. The distinction between the two stems from two sources. First, much of the information provided ex-post is not yet available in the ex-ante situation. Second, the ex-ante information is provided in a stressful situation, which requires an informative overview, as opposed to ex-post information, which is supposed to enable in depth analysis.

Furthermore, all providers of ex-post information should be required to list all assets in the cost-information – not just those that produce costs. In the current framework, it is possible that products, which cause no cost to the consumers - such as shares held -, are not listed. This can reduce the total sum of assets held, that a provider informs a consumer about. Because of this, the total sum is not a reliable number and the cost drivers in a portfolio become harder to identify.

All information must be provided both on the aggregate level and per product. The information on inducements should be split into inducements received and granted by the informing party. Both of these aspects on inducements should also list which third party granted or received these inducements.

V. ANNEX – SUGGESTIONS VISUALISED

The main body of this paper outlined multiple flaws in the information papers and suggested several improvements. Because it is hard to envisage what these changes would look like and why they are important, vzbv has opted to create the visualisation below.

The example is not intended as a template for future information documents but rather as a basis for discussions. Ultimately, the standardisation of consumer information documents is a political task. The European Commission, the European Parliament and the Council of the European Union should agree to undertake this standardisation and charge ESMA with executing it.

Aggregate Cost overview

Your total portfolio had an average value of X EUR during (Reporting Period). The following costs were deducted from your investment during this time.

Cost for the purchase of new assets (these are one-time expenses)	X%	X EUR
Cost of Service	X%	X EUR
out of this: cost of Transactions	X%	X EUR
out of this: Trading cost	X%	X EUR
out of this: cost of currency exchange	X%	X EUR
out of this: (itemized list of any other costs)	X%	X EUR
Product Costs	X%	X EUR
out of this: issuing surcharge	X%	X EUR
Sales commissions paid by the producer to (provider name)	X%	X EUR
out of this: Sum of these commissions, handed over to salesforece	X%	X EUR
Commissions paid by (provider name) to salesforce	X%	X EUR

Cost for the sale of assets (these are one-time expenses)	X%	X EUR
Cost of Service	X%	X EUR
out of this: cost of Transactions	X%	X EUR
out of this: Trading cost	X%	X EUR
out of this:	X%	X EUR
out of this: const of currency exchange	X%	X EUR
out of this: (itemized list of any other costs)	X%	X EUR
Product Costs	X%	X EUR
out of this: redemption fee	X%	X EUR
Sales commissions paid by 3rd party to (provider name)	X%	X EUR
out of this: Sum of these commissions, handed over to salesforece	X%	X EUR
Commissions paid by (provider name) to salesforce	X%	X EUR

Other Services (one-time expenses)	X%	X EUR
itemized list of all services provided for charge including postage etc.	X%	X EUR

Total of one-time expenses in (reporting period)	X%	X EUR
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Ongoing charges	X%	X EUR
Cost of Service	X%	X EUR
out of this: trailing commissions	X%	X EUR
out of this: charges for the securities account	X%	X EUR
out of this: itemized list of any other cost	X%	X EUR
Product Costs	X%	X EUR
out of this: running charges	X%	X EUR
out of this: Transactioncost of Funds	X%	X EUR
out of this: (itemized list of any other costs)	X%	X EUR
Sales commissions paid by 3rd party to (provider name)	X%	X EUR
out of this: Sum of these commissions, handed over to salesforece (intermediary name)	X%	X EUR
Commissions paid by (provider name) to salesforce	X%	X EUR

Total of all Costs	X%	X EUR
out of this: costs of service	X%	X EUR
out of this: product costs	X%	X EUR

Comparison to Benchmark		
Net performance of your portfolio	X%	X EUR
Net performance of a basket of Index products (to be determined by ESMA)	X%	X EUR
Your Portfolio has over/under -performed against the average by this much in (reporting period)	X%	X EUR

Cost by Product:

A comprehensive list of all assets held during the reporting period, including those that did not incur any cost.

Product 1		
Average value of this Asset held in (Reporting Period)		
Cost of Service	X%	X EUR
Product cost	X%	X EUR
Total cost	X%	X EUR
out of this, inducements received by (Provider) from (investment firm)	X%	X EUR
out of this: inducements paid by (provider) to (intermediary name)	X%	X EUR