

New Era of Retail Investment—European Commission Publishes Its Proposal for a Retail Investment Strategy

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On 24 May 2023, the European Commission (the “Commission”) published its proposal for a Retail Investment Strategy (the “RIS”). The RIS consists of (i) a proposed [Omnibus Directive](#) that amends several EU directives, including the Markets in Financial Instruments Directive (the “MiFID”)¹ and the Directive on Alternative Investment Fund Managers (the “AIFMD”)² (the “Omnibus Directive”), and (ii) a proposed [Regulation](#) amending the PRIIPs Regulation³ (the “Amending Regulation”).

Retail investors in the European Union are apprehensive of making investments in the capital markets. Various stakeholder consultations have revealed that retail investors are concerned with (i) the lack of access to “relevant comparable and easily understandable information” on various investment products, (ii) the risk of being misled by unrealistic claims and marketing information, (iii) conflicts of interests created by inducements paid to financial advisors by product manufacturers and (iv) unjustifiably high costs for certain investment products. The RIS seeks to address these issues and to provide retail investors with the comfort to take “full advantage” of the capital markets. It also seeks to allow retail investors to take “informed investment decisions” and to ensure investor protection through a robust regulatory framework. However, several of the proposed changes would also affect fund managers whose funds are only open for professional investors and distributors who only market products to professional clients. For example, the RIS introduces the requirement for fund managers to establish a pricing process for every managed fund, including professional funds, and imposes restrictions on fund managers with regard to costs charged to investors.

Interested stakeholders can provide feedback on the RIS through the [Commission’s website](#).

¹ Directive 2014/65/EU.

² Directive 2011/61/EU.

³ Regulation (EU) No 1286/2014.

Omnibus Directive

With the Omnibus Directive, the Commission seeks to address specific retail investor protection topics, which are outlined in more detail in the Omnibus Directive's Explanatory Memorandum.

Below is a summary of the proposed amendments per topic:

Simplify and Reduce the Information Presented to Retail Investors

Risk Warnings

MiFID firms will be required to display appropriate risk warnings in any information concerning particularly risky products that is communicated to retail clients. The use of risk warnings can be imposed by the respective national competent authority (the "NCA"). The European Securities and Markets Authority ("ESMA") is given a mandate to specify the concept of particularly risky products and the content and format of such risk warnings.

Cost Disclosure

The Commission also proposes to revise the requirements regarding the disclosure of information on costs. Information on costs should be presented in standardised format, and distributors will be required to (i) add, in a comprehensible language, an explanation to retail clients about any third-party payments specifying their purpose, quantification and impact on expected returns and (ii) provide retail clients with an annual statement on costs. ESMA is mandated to specify the format, standard terminology and explanations to be used in cost disclosure.

With the proposed changes, the Omnibus Directive seems to re-introduce the cost disclosure requirement also for distributors that market funds through non-advised services (i.e., without giving investment recommendations or providing discretionary portfolio management services) only to professional clients and eligible counterparties. This would be a real disadvantage, given that for these firms, the requirement to disclose information on costs had only recently been removed completely through the "MiFID Quick Fix"⁴.

Protect Retail Investors from Misleading Marketing Communications and Practices

Content of Marketing Communications

In addition to the existing requirements on information material distributed by MiFID firms, the Omnibus Directive proposes further provisions on marketing

⁴ Directive (EU) 2021/338.

communications with the aim to ensure that marketing materials comply with the requirement to be “fair, clear and not misleading”. This also includes the requirement to have a “balanced presentation of benefits and risks” and to be “appropriate for the target audience”. MiFID firms also have to ensure that in marketing communications addressed to retail clients, the key features and main risks of the marketed product or service are easily understandable. Equivalent requirements already apply to fund managers in relation to marketing material on funds.⁵

Organisational Measures, Management Responsibilities

MiFID firms have to put in place a policy on marketing communications and practices and implement organisational measures to ensure compliance with the related requirements. This includes regular training of staff to ensure compliance with the firm’s policy on marketing communications and practices. The firm’s management board is responsible for defining, approving and continuously monitoring the policy and related procedures. The management board also has to ensure that it receives annual reports on the firm’s use of marketing communications strategies, on compliance with the obligations on marketing communications and practices by the firm’s staff and on possible deficiencies and proposed remedies.

Conflicts of Interest, Inducements and the Introduction of a “Best Interest” Test

Ban on Inducements for Non-Advised Sales to Retail Clients

MiFID firms are currently subject to a complete ban on inducements granted to or received from third parties when they provide discretionary portfolio management services. Restrictions on granting or receiving inducements also apply when firms provide other MiFID services. These restrictions include the obligation to disclose inducements to clients and to demonstrate that the inducement is designed to enhance the quality of the service to the client (the “quality enhancement” test).

After months of speculation and heated discussions on the inducement topic in advance of the Commission’s proposal, the Omnibus Directive has now introduced a complete ban on inducements granted from manufacturers to distributors, and inducements granted from distributors to manufacturers, in relation to non-advised sales, i.e., where products are distributed through the services of reception and transmission of orders or execution of orders on behalf of retail clients. Exemptions from this ban shall only apply where (i) the distributor has acted as investment advisor to the retail client in relation to the same transaction or (ii) the benefit granted to the distributor is a remuneration for placement or underwriting services that the distributor provides to the issuer of the

⁵ ESMA, Guidelines on marketing communications under the Regulation on cross-border distribution of funds, ESMA 34-45-1272.

financial instrument that is being marketed to the retail client (however, this exemption will not apply to packaged retail and insurance-based investment products (“PRIIPs”)).

No Ban on Inducements for Investment Advisors; Strengthened “Best Interest” Test Replaces “Quality Enhancement” Test

For investment advisors, however, the RIS does not introduce a complete ban on inducements. Instead, it specifies the advisors’ obligation to act in the best interest of their clients when providing investment advice to retail clients. Under the newly introduced “best interest” test, investment advisors giving recommendations to retail clients have to (i) consider an appropriate range of financial products in their advice, (ii) recommend the most cost-efficient product from the range of suitable products and (iii) systematically recommend at least one product without features that may not be necessary for the achievement of the client’s investment objectives and that give rise to extra costs, so that retail investors are presented with an alternative and possibly cheaper option to consider.

MiFID firms that are not banned from granting or receiving third-party inducements under the proposed new rules remain obliged to ensure that the payment or receipt of an inducement does not impair compliance with their duty to act in the best interest of their clients (for advice provided to retail clients, the “best interest” test applies) and to comply with the disclosure requirement. The current requirement to also meet the “quality enhancement” test, however, is removed completely.

Avoid Undue Costs and Ensure Value for Money for Retail Investors

MiFID: Establishment of Pricing Process for PRIIPs

Enhanced product-governance requirements are imposed on manufacturers. In particular, a “value for money” test is introduced, which requires manufacturers of PRIIPs to establish a pricing process that allows them to identify and quantify all costs and charges of the product and its distribution. Equivalent requirements apply to distributors of PRIIPs, who have to consider distribution costs in their pricing process. The pricing process should clearly identify and justify the proportionality of the product’s costs in reference to the product’s performance. ESMA is given the mandate to develop, make publicly available and regularly update common cost and performance benchmarks of PRIIPs at both the manufacturing and distribution stages against which manufacturers and distributors have to compare their products prior to offering them on the market. Products that deviate from the relevant benchmark shall not be approved for marketing, unless the manufacturer or distributor can demonstrate that costs and charges are justified and proportionate.

Reporting on Costs, Charges and Performance of PRIIPs

Manufacturers of PRIIPs have to report relevant data on costs, charges and performance of PRIIPs to their NCA to enable the development of benchmarks by ESMA.

Distributors have to report to their NCA data on the distribution costs of PRIIPs, and where the manufacturer falls outside of the scope of the new reporting requirements, distributors also have to report data on the product's costs and charges, performance and level of risk.

AIFMD⁶: Protect Investors from “Undue Costs”; Establishment of Pricing Process

Same as for manufacturers of PRIIPs under MiFID, the RIS introduces a new requirement for fund managers to establish a pricing process for every fund they manage that allows them to identify and quantify all costs borne by the fund or the fund's investors. This also includes funds that are only open for professional investors. The pricing process should be based on objective criteria and methodology and include a comparison to market standards. With the pricing process, fund managers have to ensure that costs charged to investors are not “undue”. For this purpose, costs are regarded as “due” if they are (a) in line with the disclosures in the fund rules, in the fund's incorporation documents or in the PRIIPs-KID, (b) necessary for the fund to operate in line with its investment strategy and objective or to fulfil regulatory requirements and (c) borne by investors in a way that ensures fair treatment of investors, except where the fund rules or incorporation documents provide for a preferential treatment. Given the rather vague criteria for “necessary” costs, fund managers may have difficulty determining which costs can actually be considered as “due”. Fund managers have to assess at least annually whether costs charged to the fund or the fund's investors are “undue”. The responsibility for the pricing process is delegated to the fund manager's management board. Where undue costs have been charged, investors have to be reimbursed, and a report has to be made to the NCAs and financial auditors of the fund manager and the fund, respectively, and to the fund's depositary.

For funds marketed to retail investors, the pricing process also has to ensure that costs borne by investors are justified and proportionate, having regard to the fund's objectives, risk and return profile and investment strategy and considering the relevant benchmark on costs and performance to be published by ESMA. Funds that deviate from the relevant benchmark shall not be marketed to retail investors, unless the fund manager can demonstrate that costs and charges are nevertheless justified and proportionate and comply with the criteria set out in the pricing process for the fund.

Reporting on Costs and Performance of Funds

Fund managers will have to report to their NCA regularly on the costs borne by investors and the performance of the fund for each fund they manage or each share class of such fund where those share classes have different cost structures.

⁶ Equivalent amendments are proposed to the UCITS Directive (Directive 2009/65/EC).

Adapt Suitability and Appropriateness Tests to Retail Investors' Needs

Additional Requirements for Suitability and Appropriateness Test

The Commission proposes additional requirements in relation to the information that distributors have to obtain from their clients for the purpose of conducting the suitability or appropriateness test. Under the proposed new rules, investment advisors also have to consider the client's need for portfolio diversification when assessing whether a specific product or service is suitable for that client. Distributors performing non-advised services to retail clients have to assess the client's capacity to bear full or partial losses and risk tolerance, in addition to assessing the client's knowledge and experience in relation to the offered product (which is the current requirement). Distributors also have to provide clients with an explanation (in standardised form) about the purpose of the suitability or appropriateness assessment before requesting any information from the client, together with a warning about the consequences on the quality of the assessment if clients do not provide accurate and complete information.

Simplified Advice Framework

Independent advisors, on the other hand, may conduct a simplified suitability assessment on clients where their advice is limited to a range of well-diversified, non-complex and cost-efficient products.

Ensure High Professional Standards for Investment Advisors

A new Annex V to MiFID is introduced which specifies minimum requirements on knowledge and competence for investment advisors. Investment firms have to ensure that staff providing investment advice receives ongoing professional training of at least 15 hours per year in the areas of competence set out in Annex V. Compliance with these requirements has to be evidenced by obtaining a certificate.

Client Categorisation: Easing Restrictions for Investors to Qualify as Professional

Clients that do not fall into the category of the *per se* professional clients set out in MiFID Annex II section I (such as credit institutions, insurance companies or investment funds) may elect to be treated as professional clients if they meet certain criteria. "To ensure more appropriate classification of clients and to reduce administrative burdens", the Commission has proposed amendments to these criteria, including

- a reduction of the wealth criterion from EUR 500,000 to EUR 250,000; however, introducing a three-year period during which the client's financial instrument portfolio must on average have exceeded the new threshold; and

- the introduction of a possible fourth criterion to consider experience gathered outside the financial services sector by providing proof of certified education or training that evidences the client's understanding of the transactions or services envisaged and the ability to adequately evaluate the risks involved.

Legal entities may be treated as professional clients if they meet two of the following three criteria and if the legal representative or person responsible for the investment transactions on behalf of the legal entity has the required knowledge and experience:

- balance sheet total: EUR 10 million;
- net turnover: EUR 20 million;
- own funds: EUR 1 million.

Strengthening Supervisory Enforcement

To strengthen supervisory enforcement in the context of the growth of digital channels and in cross-border cases, the Omnibus Directive introduces additional powers for NCAs to improve supervisory efficiency and coordination and requires MiFID firms to provide basic reports to NCAs on their cross-border activities.

Promote Financial Literacy of Retail Investors

Finally, the Commission seeks to ensure that Member States take measures to promote financial education of retail investors.

Amending Regulation

The Amending Regulation proposes amendments to the PRIIPs Regulation that aim in particular to facilitate investor access to information set out in the PRIIPs-KID:

Electronic Format; Information on Costs

The electronic format is introduced as standard format for the PRIIPs-KID, in alignment with other regulations on pre-contractual information in the financial sector. The electronic format may be provided by means of an interactive tool that enables retail investors to generate personalised key information. Where PRIIPs offer a range of options for investments, investors should be provided with tools allowing them to access and compare the total costs for the PRIIP before they select one particular investment option.

Dashboard; ESG-Related Information

The PRIIPs-KID should also include a dashboard titled “Product at a glance” with a summary of: (a) the type of PRIIP; (b) the summary risk indicator; (c) the total costs of the PRIIP; (d) the recommended holding period; and (e) whether the PRIIP offers any insurance benefits.

The amendments also propose that information on the alignment of the PRIIP’s investments with the Taxonomy Regulation⁷ is included in the PRIIPs-KID as an indicator for retail investors to determine the environmentally related sustainability of the product. Although it is understandable that the Commission endorses the Taxonomy Regulation as the European standard for environmentally sustainable economic activities in this context, the question is whether the targeted impact could better be achieved by referring to sustainable investments under the SFDR⁸, which would include economic activities aligned with the Taxonomy Regulation. This would also better address the scarcity of sustainability-related data, in particular with regard to the (not even yet finished) framework to determine economic activities that are aligned with the Taxonomy Regulation.

Conclusion

With its proposal for a Retail Investment Strategy, the Commission aims to “simplify and reduce” information provided to retail investors, to protect retail investors from misleading marketing communications and practices and to ensure “value for money” for investors. It also aims to increase investor confidence by reducing apparent conflicts of interests resulting from third-party payments received by distributors of financial products.

Given the economic circumstances with rising interest rates and less activation to invest into private funds, lowering barriers for retail investors comes in timely. However, the lowering of barriers for retail investors also comes with heightened regulatory requirements for product manufacturers, including fund managers, and distributors. It therefore remains to be seen if the proposed changes will be sufficient to wake the potential in retail investor capital for private funds. As regards the professional investor sector, the introduction of the requirement for fund managers to avoid “undue costs” also at the level of professional funds seems very problematic and could pose particular problems in a blind pool scenario.

⁷ Regulation (EU) 2020/852.

⁸ Regulation (EU) 2019/2088.

Please do not hesitate to contact us with any questions.

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