



Council of the European Union
General Secretariat

Brussels, 28 September 2023

**Interinstitutional files:
2023/0167 (COD)**

WK 12353/2023 INIT

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MEETING DOCUMENT

From:	General Secretariat of the Council
To:	Working Party on Financial Services and the Banking Union (Retail Investment) Financial Services Attachés
N° Cion doc.:	ST 9671 2023 INIT
Subject:	Retail Investment Strategy - Presidency non-paper on inducements, 'best interest of the client' test, suitability and appropriateness and professional requirements, for discussion at the 4 and 5 October 2023 CWP

WK 12353/2023 INIT

RETAIL INVESTMENT STRATEGY

Presidency non-paper on inducements, 'best interest of the client' test, suitability and appropriateness and professional requirements, for discussion at the 4 and 5 October 2023 meeting

1. Introduction

This paper is based on Member States' written comments. It aims to guide discussions on the Commission's proposal for the corresponding amendments to Directive 2014/65/EU (MiFID II), Directive (EU) 2016/97 (IDD), Directive 2009/65/EC (UCITS Directive) and Directive 2011/61/EU (AIFMD). Member States are invited to present their views on this non-paper.

2. Inducements

2.1. Overall effects of a partial ban on inducements for non-advised sales

The Commission's proposal aims at addressing potential conflicts of interest for financial service providers and consumer detriment due to the payment and reception of inducements in the non-advised sale of financial products. In addition to the existing bans on inducements regarding independent advice and portfolio management, the proposed Article 24a (2) MiFID introduces a ban on inducements paid from manufacturers to distributors in relation to the reception and transmission of orders, or the execution of orders to or on behalf of retail clients. These investment services cover execution-only sales, i.e., cases in which no advice relationship exists between the investment firm and the client. Similarly, the proposed Article 29 and new Article 29a of the IDD introduces a ban on inducements paid from manufacturers to distributors in relation to non-advised sales of IBIPs.

Quite a few Member States do not support the partial ban proposed by the Commission due to potential negative implications affecting both the supply and demand side.

Supply side

- Less profitability in the RTO and execution-only services could lead to a reduction in the supply of these products and to an increase in price of such services.
- The potential disruptive impact on existing business models. For example, digital service providers might be negatively affected. Moreover, the partial ban could stimulate firms to offer non-independent investment advice.
- The development of new, innovative business models could be hindered.

Demand side

- The partial ban could lead to possible exclusion of low-income retail investors from seeking this investment service if the market starts to apply explicit fees.
- The partial ban and subsequent possible introduction of explicit fees could increase retail investors' interest in unregulated investment instruments.
- The partial ban could lead to higher premiums for retail investors investing in insurance-based investment products.

Other reasons

- The ban could have an asymmetric impact in the domestic capital markets. Consequently, one delegation suggests leaving it to the discretion of Member States whether to deviate from the rules on inducements.
- The lack of data makes it difficult to evaluate potential negative unintended consequences.

One Member States suggests limiting (instead of banning) the payment of inducements to the distributor when selling an IBIP product inadequate to satisfy the consumer's needs. The distributor would receive a full incentive for selling a product adequate to the customer's needs.

On the other hand, a few Member States support the partial ban to avoid potential conflict of interest. One Member State views the partial ban as a step forward but regrets that the proposal did not contemplate the full ban.

Finally, one delegation would be interested in further assessing how the partial ban affects market competition given that some services would be covered by the ban while others would not. Other Member States consider that the proposal contains various undefined terms and unclear exceptions. Therefore, assessing the impact of the proposal constitutes a difficult task.

Member States are invited to present their views on:

- a) whether they support the Commission's proposal on banning inducements for non-advised sales
- b) whether they would propose to clarify/adjust the proposed approach.

2.2. [Scope of and exemptions to a partial ban on inducements for "execution-only" sales.](#)

1) Amendments to MiFID

This provision of the proposal should apply in addition to the existing bans on inducements regarding independent advice and portfolio management, which are maintained in MiFID. According to Article 24a (3) of the proposal, the ban on inducements in relation to the services of execution of orders and reception and transmission of orders is not applicable to situations in which investment firms provide advice to the same client relating to one or more transactions covered by that advice.

One delegation asks to clarify the meaning of such provision in the case of an investment firm providing a full advisory service to the client, but ultimately the client does not follow the advice given in part or

not at all (but requests that an order is executed on a different security than the one advised on). It has been argued that the firm should still be able to use the provisions of Article 24a (3) MiFID and settle the incentive fee for each transaction. Another delegation considers that the implementation of this exemption is challenging since the distributor will have to prove the link between the transaction and the previous advice provided to the client. Another Member State is concerned about the potential future interpretation of “relating to” and would welcome further clarification because there is a risk that investment firms will interpret this rule broadly and might unreasonably limit the access to execution-only products.

One Member State suggests replacing “pay or receive” with “pay or receive and retain”, for the proposed ban on execution-only trades. This delegation considers that the suggested wording would entail that investment firms will most likely be required to establish new ‘clean’ rebate free share class funds that are listed. However, if the wording is changed to “pay or receive and retain”, the investment firms could offer existing funds with fees and commissions because they could then just be passed on to the investors.

Article 24a (5) of the proposal also states that the partial ban on inducements should not apply to the execution or reception and transmission of orders related to minor non-monetary benefits which do not exceed EUR 100 or are of a scale and nature that they could not be judged to impair compliance with the duty to act in the best interest of the retail investor, as long as they are clearly disclosed. One delegation asks for clarification about what is covered by those “minor non-monetary benefits”. Another one wonders at what level does the calculation need to take place (at the level of the recipient/payer/client/specific instrument, etc.). One Member State would also like to know if the total value has to be calculated per product or per investor, or in another way.

Article 24a (6) of the proposal includes the exemption to the ban for those payments in relation to research. Several Member States have mentioned the interaction of this provision with the negotiations of the Listing Act.

Amendments to IDD

New Article 29a (1) IDD of the proposal states that the prohibition of inducements should not apply to minor non-monetary benefits of a total value below EUR 100 per annum or of a scale and nature such that those benefits do not impair compliance with the insurance intermediary’s or insurance undertaking’s duty to act in the best interests of their customer provided those benefits have been clearly disclosed to the customer. One Member State asks to clarify if these are alternative and not cumulative conditions.

Member States are invited to present their views on:

- a) Whether they support the Commission’s proposal regarding the scope and exemptions to the ban of inducements.
- b) Whether they would propose to clarify/adjust the proposed approach.

2.3. Ban on inducements for portfolio management services.

Article 24(8) MiFID II states that Member States shall ensure that investment firms shall “not accept and retain” any fees or commissions when they provide portfolio management. This paragraph 8 is

deleted in the proposal and new Article 24a (1) introduced by the current proposal states that investment firms shall not “pay or receive” any fee or commission when they provide portfolio management.

Several Member States claim that this modification has the following consequences:

- The asymmetric treatment of portfolio managers (who are no longer able to accept and pass payments to clients) related to independent advisors (who can do that, since no change is proposed to Article 24 (7) MIFID).
- The possibility of preventing portfolio managers from relying on private banking to ‘distribute’ their mandates to investors, as the private bank is longer able to be remunerated for the distribution.

Finally, one delegation suggests replacing “pay or receive” with “pay or receive and retain.”

Member States are invited to present their views on:

- a) whether they support the Commission’s proposed wording or suggest amendments.
- b) whether they would propose to clarify/adjust the proposed approach.

2.4. Review clause

The proposal includes a review clause requiring the European Commission to assess the effects of third-party payments on the retail investor segment 3 years after the transposition of the Directive, to determine whether the potential conflicts of interest caused by third-party payments have been reduced.

Several delegations propose to amend this provision. They believe that 5 years is a better time horizon for a comprehensive assessment of the impact of the new measures. Moreover, a few delegations consider that an assessment should be carried out on the whole system. Finally, one delegation is concerned about the interaction of such review clause with a general review of the IDD.

Member States are invited to present their views on:

- a) Whether they support the Commission’s proposal for the review clause.
- b) Whether they would propose to amend it, in particular as regards the proposed timeline.

3. ‘Best Interest of the client’ test

The Commission’s proposal introduces a strengthened ‘best interest of the client’ test so that retail investors’ best interests are protected uniformly. This provision introduces a new test with clear criteria which will be applied both in MiFID and IDD (a test which replaces the existing ‘quality enhancement’ test of MiFID, and the ‘no detriment’ test of IDD). The Commission’s proposal contains different requirements that must be met by financial advisors. Financial advisors have to, as a minimum (i) base their advice on an assessment of an appropriate range of financial products, (ii) recommend the most cost-efficient financial product from the range of suitable financial products, and

(iii) offer at least one financial product without additional features which are not necessary to the achievement of the client's investment objectives and that give rise to additional costs, so that retail investors are presented also with alternative and possibly cheaper options to consider.

Amendments to MiFID

While a number of Member States see the merits of strengthening the "best interest" test to address shortcomings in the MiFID II rules on advice, some Member States are concerned about the complexity and unclarity of (some elements of) the 'best interest of the client' test. Therefore, these delegations argue that it is difficult to anticipate whether the benefits of the test could outweigh its high costs of implementation. One Member State goes even further by point out that this provision sets very specific requirements for providing investment advice which could lead to recommendation of products regardless of the customer's needs.

Several Member States ask for clarification in relation to the 3-criteria laid down by the text as proposed:

- i) As regards the first criterion, quite a few delegations ask to clarify whether the requirement is limited to products that are already included in the investment firm's or insurance distributors' services and distribution channels or does the requirement have a broader scope, including for example third party products. Another delegation considers that the provision needs to be changed to make explicit that it does not force distributors to operate within an open architecture.
- ii) Regarding the second criterion, a few delegations point out that this provision needs to be refined by clarifying the notion of cost-efficient financial instruments in level 1. Other delegations support including some qualitative aspects given that the financial product with the lowest costs might not always be in line with the client's goals. Focusing exclusively on cost-efficiency could lead to a biased recommendation to purchase products without active management, such as ETFs.
- iii) The third criterion also raises some questions. Some delegations ask to improve the definition of "additional features. Furthermore, one delegation suggests deleting this provision because assessing whether a financial instrument causes extra costs or not without contributing to the client's investment objectives, can be difficult, burdensome and bear a risk of legal liability both for firms and supervisors. This delegation also believes that excluding all products that have additional features but are more expensive would also reduce the choice of available financial instruments for the clients. Additionally, one delegation asks to clarify how advisors who only distribute a single product, or a few products are supposed to meet i) the criterion for an "appropriate range" of products and ii) the requirement to offer an additional product without features that may not be necessary. This delegation also highlights that for non-MiFID firms providing investment advice e.g. UCITS management companies and AIFMs, this requirement may have unintended negative consequences. Given that these firms generally only advise on a limited range of funds' shares or units managed by themselves, the appropriate range requirement may force them to provide advice on other investment products about which they do not necessarily have enough knowledge and expertise.

Amendments to IDD

Member States have also similar concerns for IBIPs. Several delegations highlight that these requirements might exclude non-independent distributors.

Member States are invited to present their views on

- a) Whether they support the Commission's proposal on the requirements that must be met regarding the 'best interest' test.
- b) Whether they would propose to clarify/adjust the proposed approach.

4. Suitability and appropriateness

The Commission's proposal aims at clarifying and strengthening the requirements that distributors need to comply with when assessing the suitability of a recommendation or the appropriateness of a financial product for the retail investor, by amending Article 25 MiFID and Article 30 IDD.

4.1. Information requirements

The Commission's proposal requires investment firms, insurance undertakings and insurance intermediaries distributing insurance-based investment products to (i) explain the purpose of the assessments to clients and customers in a clear way, (ii) obtain all relevant information from clients which may be necessary and proportionate for the assessments, (iii) inform retail investors about the consequences on the quality of the assessment if they do not provide accurate and complete information and (iv) provide a suitability assessment report sufficiently in advance of the conclusion of the transaction to enable clients to receive additional clarifications, where needed.

Amendments to MiFID

Some Member States suggest clarifying the meaning of "sufficiently in advance". One of these delegations points out that current Article 25, as it currently stands already state that suitability assessments must be provided before the transaction is made, thus making this proposed requirement unnecessary. Another delegation suggests changing this notion "in good time", arguing that this wording is better suited when a client asks for a transaction to be executed immediately after receiving investment advice.

A few Member States note that the proposed report on the information collected for the purpose of the suitability or appropriateness assessment is not necessary, as investors already receive information during these assessments and the goal of the overall proposal is to reduce information overload.

Amendments to IDD

One delegation suggests that the customers should be clearly informed about the possibility to request the report on the information collected for the suitability or appropriateness assessment.

4.2. Suitability assessment

The proposal made by the Commission encompasses assessing the need for portfolio diversification within the suitability assessment. The proposal introduces the possibility for independent advisors to provide advice limited to a range of diversified, non-complex and cost-efficient financial instruments with less information about the client.

Amendments to MiFID

Some delegations consider that these adjustments are adequate to ensure that the right products are offered. Several Member States suggest better defining the notions “well-diversified”, “non-complex” and “cost-efficient”. Others note that lowering information requirements for retail clients might have an impact on the advice received. Thus, retail investors must clearly understand the differences between “regular” and “simplified” advice.

A few delegations support the assessment of the need for portfolio diversification, notably because it may foster investments in different asset classes. Some of the suggestions of Member States include:

- Ensuring that this assessment does not become an excessive administrative burden.
- Limiting this requirement to portfolio-based advice therefore excluding situations when advice is given on a “one-off” basis (in the latter case, assessing the whole portfolio of the client might be too difficult for the advisor, who does not maintain an on-going relationship with the client).
- Addressing what happens when the client is interested in different levels of risk and diversification for different parts of the portfolio and when advisors are only competent to advise on a particular range of products, thereby not able to assess the need for portfolio diversification.

Amendments to IDD

One delegation does not see the need to introduce modifications in the current suitability test which is already very comprehensive. This delegation also wonders whether the activities of insurance undertakings/distributors should include investment advice and how it is possible for an insurance undertaking to provide an independent investment advice. Another delegation asks for clarification on which should be the advisors' criteria when the client is interested in different levels of risk and diversification for different parts of the portfolio and when advisors are only competent to advise on a particular range of products.

4.3. Appropriateness assessment

The Commission’s proposal provides for an expanded scope of the client’s information which intermediaries need to obtain and assess when considering the capacity to bear full or partial losses and risk tolerance. In case of a negative outcome of the appropriateness assessment, the intermediary may only proceed with the transaction at the client’s explicit request.

Amendments to MiFID

Some Member States support the proposal. However, a few delegations suggest that adding the capacity to bear losses might give the investor the perception that a suitability assessment (i.e., investment advice) is being carried out, and this is not always desired by the client. Other delegations propose clarifying the distinction between suitability and appropriateness assessments (the former being used for providing investment advice and portfolio management, the latter for execution and RTO services). Another Member State suggests exempting firms from carrying out the appropriateness test when the service is provided to a professional client in line with Article 56(1) of Delegated Regulation (EU) 2017/565.

Amendments to IDD

A few Member States do not support introducing the proposed requirements which they consider amounting to advice requirements in the context of a non-advised sale. Several delegations suggest excluding non-complex products and activities carried out at the initiative of the customer from the new obligations. Finally, a few delegations consider that the term non-complex is not clearly defined under Directive 2014/65/EU and that that term as well as the expression "difficult for the customer to understand", should both be clarified.

4.4. Report on insurance activities (art.30 paragraph 5)

Several Member States consider that the content of the report is not clear. One delegation suggests providing the report in electronic format instead of on a durable medium. Finally, one delegation supports regulating at level I instead of through delegated acts the provisions on how insurance undertakings/distributors should comply with the obligations set out in article 30.

Member States are invited to present their views on:

- a) Whether they support the Commission's proposal on information requirements and the suitability and appropriateness assessments.
- b) Whether they would propose to clarify/adjust the proposed approach.

5. Professional requirements

The Commission's proposal aims at ensuring high professional standards for investment advisors.

Thus, it includes amendments to Article 24d MiFID and a new Annex V to MiFID as well as amendments to Article 10 and Annex 1 IDD, to strengthen and align the requirements on the knowledge and competence of investment advisors set out in MiFID II and IDD. The amendments include specific requirements which build on ESMA Guidelines and additional elements regarding sustainable investments. Compliance with the requirements will require obtaining a certificate.

Various delegations suggest adding some clarifications:

- to ensure proportionality between professional requirements and responsibilities.
- to better delineate how and when to prove that the requirements are met (certificates, officially recognized training institutions, in-house trainings, etc.)
- to evaluate the resources that Member States will need to devote to having in place mechanisms to control and assess the professional requirements on a regular basis; and
- To provide for sufficient transition periods to enable investment firms to meet the new criteria.

Concerning indemnity insurance covering and financial capacity, several delegations have asked for justification of going back to the amounts established in 2016, considering that they have been recently revised.

Member States are invited to present their opinion on:

- a) Whether they support the Commission's proposal on professional requirements.
- b) Whether they would propose to clarify/adjust the proposed approach.