REVISION OF MiFID 2
Investor protection
-
"Other issues" annex

AMAFI Proposals

1. ARTICLE 62.2: 10% WARNING

1.1. Issue

Article 62(2) of MiFID 2 Delegated Regulation 2017/565 requires ISPs that *"hold a retail client account that includes positions in leveraged financial instruments"* to warn the client when the value of any of these instruments decreases by 10% compared to its initial value (and for each multiple of 10%). Three cumulative conditions must be met for this obligation to apply:

(1) having a retail client;
(2) holding an account for that client;
(3) such account includes a "leveraged" financial instrument.

The drafting of condition (1) does not require any comment.

In contrast, the scope of conditions (2) and (3) raises several questions:

- What does "*holding a retail client account*" refer to?
- Under what circumstances should a financial instrument be considered to be *"leveraged"* within the meaning of Article 62(2) of MiFID 2 Delegated Regulation? In particular, should a financial instrument marketed for hedging purposes only be considered to be leveraged?

AMAFI therefore proposes to take advantage of the MiFID 2 revision project to clarify these issues.

Firstly, AMAFI proposes to clarify the meaning of "*holding an account*" by expressly referring to the ancillary service of safekeeping defined in Annex I of MiFID 2.

Secondly, AMAFI proposes to exclude financial instruments marketed solely for hedging purposes from the scope of this obligation. The very function of a financial instrument used for hedging purposes is to reduce or eliminate an underlying risk, in particular in relation to the business activities of retail investors. Therefore, a financial instrument marketed to a client solely for hedging purposes does not increase that client's exposure to the underlying risk but, instead, reduces or eliminates that risk. Furthermore, in this situation, warning clients could lead them to take an investment decision that is contrary to their original objective. Although the "value" of the financial instrument may fluctuate over time, this does not impact the amount of the hedge as defined at the time the investment is made. So long as the hedged risk continues to be hedged it does not seem productive to warn retail investors of changes in the value of their hedge. If an investor were to reduce his position after receiving a warning, he would put himself at risk with regard to his original hedging objective, which, in principle, would not be in his interest.

1.2. Proposed legal amendment

Article 62 of MiFID 2 Delegated Regulation 2017/565

[…]

2. Investment firms that **provide a safekeeping service as referred to in Section B(1) of Annex I of Directive 2014/65/EU to** ~~hold~~ a retail client ~~account~~ that includes positions in leveraged financial instruments or contingent liability transactions, **unless such instruments have been marketed or such transactions have been carried out solely for hedging purposes**, shall inform the client, where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. Reporting under this paragraph should be on an instrument-by-instrument basis, unless otherwise agreed with the client, and shall take place no later than the end of the business day in which the threshold is exceeded or, in a case where the threshold is exceeded on a non-business day, the close of the next business day.

2. INTERVENTION MEASURES

2.1. Issue

Pursuant to Article 40 of MiFIR, ESMA may take temporary intervention measures to prohibit or restrict the marketing of certain financial instruments. As the name suggests, these restrictions are meant to be "temporary" and may be imposed for a maximum period of three months (*MiFIR, Article 40(6)*). However, these measures are renewable and no limit is set on the number of possible renewals (ESMA's website states: *"There is no limit to the number of times ESMA could renew product intervention measures"*).

In parallel, competent authorities also have the possibility to take intervention measures to prohibit or restrict the marketing of certain financial instruments (*MiFIR, Article 42*).

Therefore, an investment firm may be subject to two similar but not totally identical measures: a measure adopted by ESMA and a measure adopted by the regulator of the Member State in which it markets its products.

AMAFI acknowledges that the principle of adopting intervention measures is legitimate and beneficial in order to properly protect retail investors, especially in light of the very aggressive marketing practices that have developed in recent years with respect to certain particularly risky products. Nevertheless, it also considers that the fact that different intervention measures may potentially coexist indefinitely is not justified and creates legal uncertainty for financial operators.

Accordingly, AMAFI proposes that if a Member State has implemented national measures equivalent to measures that ESMA has published and recognised, ESMA's measures should cease to apply in that Member State, thereby avoiding the coexistence of divergent measures[1].

Moreover, given the temporary and exceptional nature of this power of intervention granted to ESMA, it seems necessary that ESMA consults the various stakeholders affected by its intervention measures before implementing them or deciding to renew them.

[1] MiFIR Article 40.7 only resolves the situation where a competent authority has implemented national measures prior to those adopted by ESMA.

2.2. Proposed legal amendment

Article 40 of MiFIR

[…]

3. When taking action under this Article, ESMA shall ensure that the action:

a) does not have a detrimental effect on the efficiency of financial markets or on investors that is disproportionate to the benefits of the action;

b) does not create a risk of regulatory arbitrage; and

c) has been taken after consulting the **different stakeholders who would be affected by this decision, in particular competent authorities, investors and investment firms** ~~public bodies competent for the oversight, administration and regulation of physical agricultural markets under Regulation (EC) No 1234/2007, where the measure relates to agricultural commodities derivatives~~.

Where a competent authority or competent authorities have taken a measure under Article 42, ESMA may take any of the measures referred to in paragraph 1 without issuing the opinion provided for in Article 43.

[…]

6. ESMA shall review a prohibition or restriction imposed under paragraph 1 at appropriate intervals and at least every three months. If the prohibition or restriction is not renewed after that three-month period it shall expire.

Before any renewal, the stakeholder consultation laid down in paragraph 3(c) shall also be carried out.

Prohibitions or restrictions imposed pursuant to paragraph 1 and any extensions thereof shall cease to apply to Member States that have implemented similar national provisions approved by ESMA.

[…]

3. PROVISION OF INFORMATION

MiFID II did not revamp the investment firms' duty to provide of information to their clients.

As a matter of fact, Article 3 of Delegated Regulation (EU) 2017/565[2] supplementing MiFID II is nothing more than Article 3 of Directive 2006/73/EC[3] implementing MiFID I. It sets in stone the supremacy of paper unless the client, amongst other conditions, formally decides otherwise.

This requirement, which dates back to the inception of MiFID, in the early 2000's, is no longer suited to the reality of the relationships between investment firms and clients and goes counter to the Union's sustainable growth objectives, without providing better information to the said clients.

[2] Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.
[3] Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

For those reasons, an amendment to aforementioned Article 3 is proposed.

3.1. Meeting new economical and environmental demands while still providing appropriate information to clients

➢ ***Meeting dematerialisation and digitalisation demands***

Digitalisation, driven by ever-changing technologies and increasingly demanding clients, has been a reality for many years, including in the financial sector.

For investment firms, innovating towards dematerialisation and constantly improving responsiveness is a matter of survival.

The regulatory framework governing the services provided by these actors must evolve in parallel so as not to penalise them in their change process.

The choice of paper as the default option for the provision of information to clients is no longer appropriate: it is inconsistent with investment firms' economical requirements of digitalisation and constitutes a major obstacle to the responsiveness sought by their clients.

➢ ***Meeting environmental challenges: sustainable finance***

Sustainable growth constitutes one of the EU's priorities. The Commission supports transition towards a sustainable financial system and adopted in March 2018 its action plan from which followed regulatory initiatives currently under review. More broadly, in its reflexional document "A sustainable Europe by 2030", it noted in January 2019: "Sustainable development is development that meets the needs of current generations without compromising the ability of future generations to meet theirs" and insisted on the crucial importance of rational consumption.

Any massive use of paper is irreconcilable with these objectives.

➢ ***Promoting clients' proper information***

There is no evidence that the provision of paper-based information has any bearings on the quality of information delivered to the client. As a matter of fact, sending paper documents can actually prove to be ineffective in that regard: incorrect recipient or department, obsolete address, difficulties in updating clients' contact details, loss of documentation (…) with a strong risk that clients do not consider or process the said documentation. Investment firms have further noticed, in relation to paper-based information, a low feedback rate even where a response is actually required.

In addition to its benefits in terms of real access to clients, a digital document addresses two key concerns: storage and ease of retrieval allowing a swift access to items which the client may wish to refer to.

Furthermore, and in any case, building a framework around the use of digital mediums guarantees a level of protection at least equivalent to that of paper. It is incidentally the position that the French authorities adopted in the context of dematerialisation of contractual relationships in the financial sector[4].

[4] Ordonnance n°2017-1433 of 4 October 2017 regarding dematerialisation of contractual relationships in the financial sector

3.2. Proposed amendment

Article 3 of MiFID 2 Delegated Regulation 2017/565

1. Where, for the purposes of this Regulation, information is required to be provided in a durable medium as defined in Article 4(1) point 62 of Directive 2014/65/EU investment firms shall have the right to provide that information in a durable medium other than on paper only if :

(a) the provision of that information in that medium is appropriate to the context in which the business between the firm and the client is, or is to be, carried on; and

(b) the person to whom the information is to be provided, when offered the choice between information on paper or in that other durable medium, ~~specifically chooses the provision of the information in that other medium~~ **has not specifically chosen the provision of information on paper**.

2. Where, pursuant to Article 46, 47, 48, 49, 50 or 66(3) of this Regulation, an investment firm provides information to a client by means of a website ~~and that information is not addressed personally to the client~~, investment firms shall ensure that the following conditions are satisfied:

(a) the provision of that information in that medium is appropriate to the context in which the business between the firm and the client is, or is to be, carried on;

(b) the client ~~must specifically consent to the provision of that information in that form;~~ **when offered the opportunity to have this information personally addressed, did not specifically choose the provision of information in that manner;**

(c) the client must be notified electronically of the address of the website, and the place on the website where the information may be accessed;

(d) the information must be up to date;

(e) the information must be accessible continuously by means of that website for such period of time as the client may reasonably need to inspect it.

3. For the purposes of this Article, the provision of information by means of electronic communications shall be treated as appropriate to the context in which the business between the firm and the client is, or is to be, carried on where there is evidence that the client has regular access to the internet. The provision by the client of an e-mail address for the purposes of the carrying on of that business shall be treated as such evidence.

4. SUITABILITY ASSESSMENT

4.1. Guidelines on product knowledge

➢ ***Issue***

As it made known when the Guidelines were being drafted, AMAFI strongly objects to Guideline 7 "Arrangements necessary to understand investment products" of ESMA's Guidelines on Suitability[5]. Since MiFID 2 entered into force, and contrary to MiFID 1, issues of product knowledge applicable to the ISP that markets such products are now governed by the Product Governance system and, therefore, should no longer be included in the Suitability system.

[5] ESMA guidelines on certain aspects of the MiFID II suitability requirements, French version dated 6 November 2018 (*ESMA35-43-1163*).

This Guideline is particularly detrimental because the obligations it sets out are, at best, redundant and, at worst, in contradiction with Product Governance obligations: for example, paragraph 72 requires that an investment firm that provides advice (a "distributor" for Product Governance purposes) obtain information on financial instruments from several data providers; however, the Product Governance provisions stipulate that the information to be considered is the information provided by the Manufacturer (i.e. a single data source).

➢ ***Proposed legal amendment***

ESMA Guidelines on Suitability - General Guideline 7

AMAFI proposes that General Guideline 7 be deleted.

4.2. Consideration of concentration risk

➢ ***Issue***

Paragraph 81 of ESMA's Guidelines on Suitability requires ISPs to take into account credit risks and, in particular, to verify that the client's portfolio does not have products issued by a single issuer or too few issuers ("concentration risk"). However, firstly, investment firms are not aware of all financial instruments their clients hold with other institutions, so this review of credit/concentration risk will only concern a portion of the client's assets and will be an incomplete review. Secondly, pursuant to the obligations on investor information and the drafting of sales documentation, investors are already fully informed that if they invest in product X they will be exposed to credit risk on issuer Y.

Therefore, AMAFI suggests that ESMA should recommend, as a best practice, that investment firms inform investors when, to their knowledge, investors' credit risk may be deemed overly concentrated. However, firms cannot be required to closely and systematically monitor this risk or to apply methodologies that include threshold mechanisms.

➢ ***Proposed legal amendment***

ESMA Guidelines on Suitability – Paragraph 81

When a firm conducts a suitability assessment based on the consideration of the client's portfolio as a whole, it should ensure an appropriate degree of diversification within the client's portfolio, taking into account the client's portfolio exposure to the different financial risks. ***If it deems that credit risk is overly concentrated on too few issuers, it shall inform the client.*** ~~*(geographical exposure, currency exposure, asset class exposure, etc.).* In cases where, for example, from the firm's perspective, the size of a client's portfolio is too small to allow for an effective diversification in terms of credit risk, the firm could consider directing those clients towards types of investments that are "secured" or per se diversified (such as, for example, a diversified investment fund).~~

~~*Firms should be especially prudent regarding credit risk: exposure of the client's portfolio to one single issuer or to issuers part of the same group should be particularly considered. This is because, if a client's portfolio is concentrated in products issued by one single entity (or entities of the same group), in case of default of that entity, the client may lose up to his entire investment. When operating through so called self-placement models, firms are reminded of ESMA's 2016 Statement on BRRD24 according to which "they should avoid an excessive concentration of investments in financial instruments subject to the resolution regime issued by the firm itself or by entities of the same group". Therefore, in addition to the methodologies to be implemented for the assessment of products credit risk (see guideline 7), firms should also adopt ad hoc measures and procedures to ensure that concentration with regard to credit risk is effectively identified, controlled and mitigated (for example, the identification of ex ante thresholds could be encompassed).*~~

4.3. Switching investments

➢ ***Issue***

Paragraph 91 of ESMA's Guidelines on Suitability requires ISPs to include in the suitability report *"the reasons why the benefits of the recommended switch are greater than its costs".* However, Levels 1 and 2 of MiFID 2 do not impose any formal requirements as to the manner in which ISPs are to provide this information to retail clients. As Level 3 cannot create additional obligations, AMAFI proposes that this paragraph requiring that such information be included in the suitability report be deleted.

➢ ***Proposed legal amendment***

ESMA Guidelines on Suitability – Paragraph 91

When providing investment advice, a clear explanation of the reasons why the benefits of the recommended switch are greater than its costs should be provided ~~included in the suitability report the firm has to provide to the retail client before the transaction is made~~.