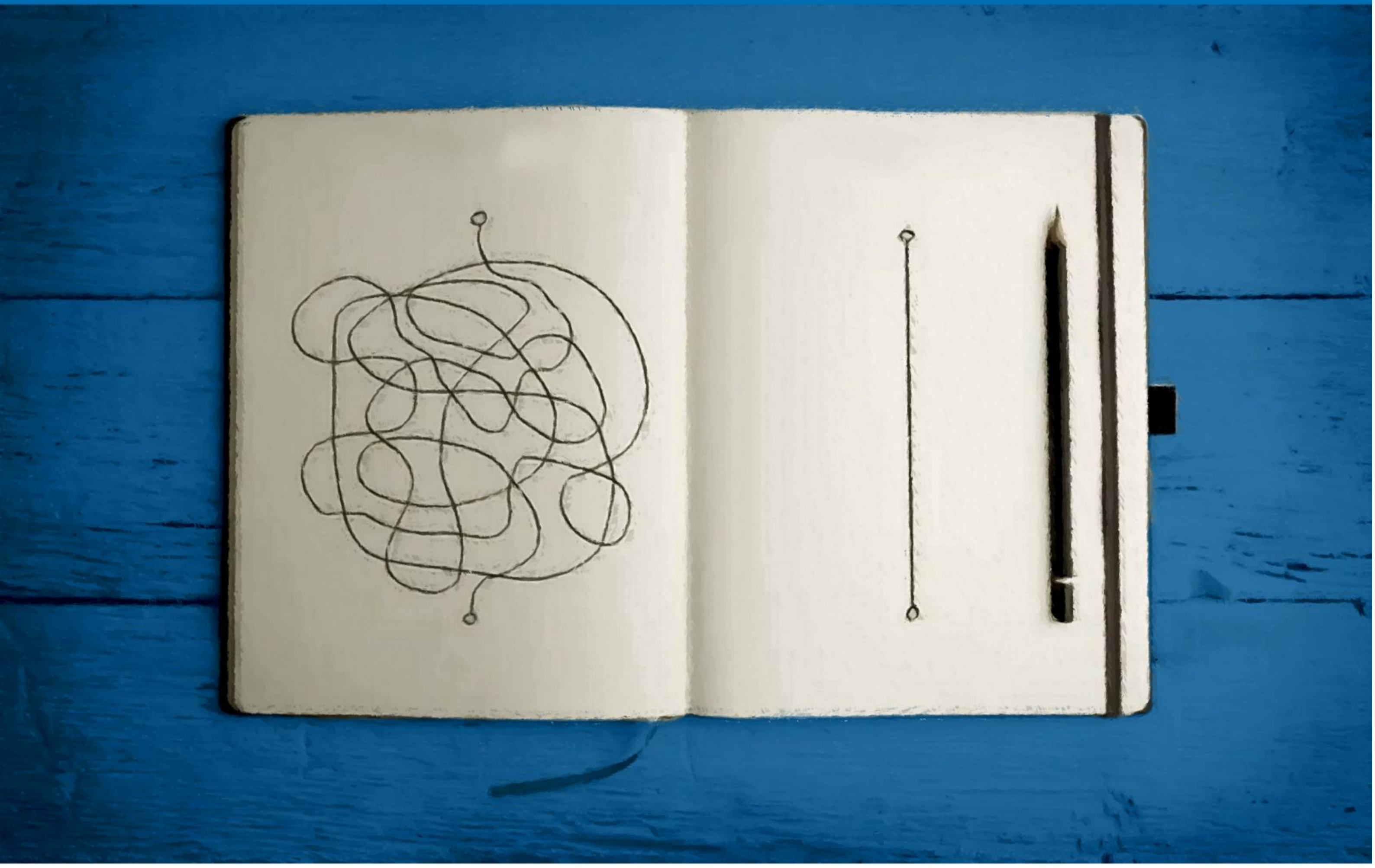
Simple Products for Retail Investors

What They Look Like vs What They Should Look Like

December 2021



BETTER FINANCE

The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

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About BETTER FINANCE

BETTER FINANCE, the European Federation of Investors and Financial Services Users, is the public interest non-governmental organisation advocating and defending the interests of European citizens as financial services users at the European level to lawmakers and the public in order to promote research, information and training on investments, savings and personal finances. It is the one and only European-level organisation solely dedicated to the representation of individual investors, savers and other financial services users.

BETTER FINANCE acts as an independent financial expertise and advocacy centre to the direct benefit of European financial services users. Since the BETTER FINANCE constituency includes individual and small shareholders, fund and retail investors, savers, pension fund participants, life insurance policy holders, borrowers, and other stakeholders who are independent from the financial industry, it has the best interests of all European citizens at heart. As such its activities are supported by the European Union since 2012.

EXECUTIVE SUMMARY

Individual, non-professional investors have an increased appetite for investing in capital markets following the global health pandemic. Evidence in several jurisdictions shows that many new, young, and tech-savvy savers started to invest without professional assistance through what is called *execution-only services* under EU law[1].

<u>Execution-only</u> services are those where financial products or services are provided at the explicit request of the client and on the client's own initiative, i.e., without any proposition or additional service from a professional, e.g., when a client simply asks a broker to buy equities.

Manufacturers or distributors of financial products are forbidden under EU law to distribute financial products under the *execution-only regime* if the products are deemed complex. This rule applies both under the MiFID II framework (securities markets) and under IDD (insurances).

Simple vs complex products

The European Supervisory Authorities (ESMA, EIOPA, EBA) have a legal duty to promote simplicity, according to their founding Regulations:

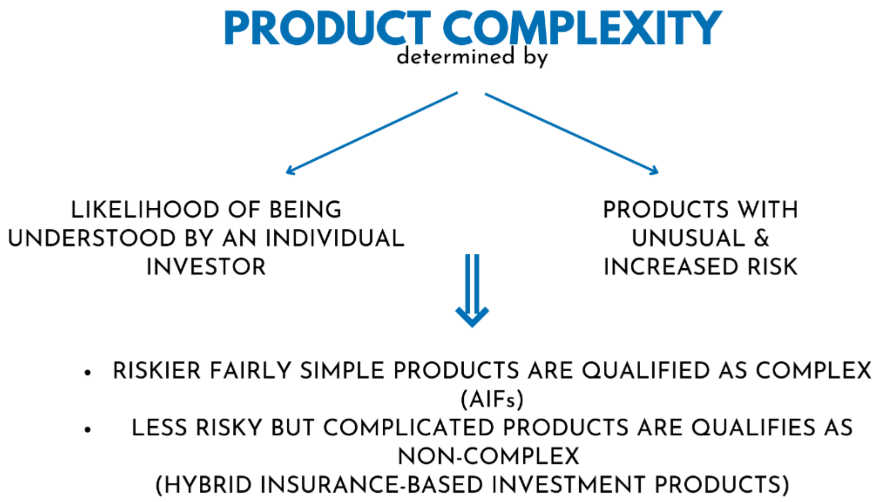
"*The Authority shall take a leading role in promoting transparency, simplicity and fairness in the market for consumer financial products or services across the internal market* (…) – Art. 9(1),

Generally, complex products are those whose structures, either regarding costs, risks, or other features, make it difficult for "retail" clients to understand. EU law took a novel approach and assumed all financial instruments are complex, with the exception of a few categories expressly defined as "*simple*". In this sense, both MiFID II and IDD single out product categories that are considered, by default, non-complex. Further, EU law created an additional residual category ("*other non-complex products*") which prescribes certain criteria to be met in order to qualify as a simple product, which enables product manufacturers to design and sell more products (aside from those expressly listed in MiFID II and IDD) through execution-only services.

BETTER FINANCE analysed the applicable frameworks to better understand what makes a product *complex* under EU law. Our analysis concludes that product complexity is seen through two alternative lenses: either the likelihood to be understood by the *average* retail investor, or its unusual or increased risk. This leads to situations where riskier, but straightforward (in light of their functioning) products are considered complex – such as alternative investment funds – and less risky, but complicated products – such as hybrid insurance-based investment products – are considered non-complex (for example "*products with a range of underlying investment options, products where it is possible to select multiple asset management strategies at different times during the duration of the contract, or products which provide a leveraged exposure to underlying investments*"[2]).

[1] See BETTER FINANCE's report on *Consumer Access to EU Equity Trading Data* (April 2021) available at: https://betterfinance.eu/publication/consumer-access-to-eu-equity-trade-data/.

[2] EIOPA, *Final Report on Guidelines under the Insurance Distribution Directive on Insurance-based investment products that incorporate a structure which makes it difficult for the customer to understand the risks involved* (EIOPA-BoS-17/204, 11 October 2017) para. 1.54, p. 19, available at: https://register.eiopa.europa.eu/Publications/Reports/Final_Report_IDD_guidelines_execution_only.pdf.



Source: BETTER FINANCE own composition, © 2022

The research team took a closer look (through mystery shopping) at several examples of products available for sale on execution-only platforms. Our exercise found several brokerage platforms where derivatives or complex insurance-based investment products were available to retail clients without a suitability or appropriateness assessment.

However, we could not find any shares or units in alternative investment funds (AIFs) available to buy on any of the brokerage platforms analysed under the execution-only regime. This raises questions regarding the understanding of the non-complex product regime, especially since in many jurisdictions (such as France) a lot of AIFs are sold as ordinary retail funds: either through advised services or packaged into other products, AIFs are not an uncommon investment among retail investors.

Execution-only regime

BETTER FINANCE critically analysed several aspects of the execution-only regime in light of inconsistencies found in practice. The suitability and appropriateness assessments are evaluations that must be made on every occasion that the client is proposed, or wants to undertake, a complex financial transaction, meaning that general suitability and appropriateness assessments are not compliant with the law. In addition, product complexity under EU law also factors in the financial risk of the product, besides the likelihood of the retail client being able to understand the product. If such a choice is kept, then EU law should add a category of *toxic products* as well. Accordingly, in BETTER FINANCE's view, toxic products are those that have a "*high probability of generating losses in real returns for the individual investor*".[3]

Finally, the Pan-European Personal Pension product (PEPP) will be launched, opening a new, innovative category of long-term and retirement savings products to retail investors. In this light, BETTER FINANCE believes that the basic PEPP should be considered, by default, a non-complex product, and should be available to buy under the execution-only regime.

[3] See BETTER FINANCE's Answer to the Call for Evidence of the Joint Committee of the European Supervisory Authorities on Potential product intervention measures on contracts for differences and binary options to retail clients (5 February 2018).

POLICY RECOMMENDATIONS

Make the default PEPP a simple product

The Regulation on the Pan-European Personal Pension (PEPP) product came into force on March 22, 2022. While national competent authorities have not yet implemented the level 2 and 3 regulations to enable financial product manufacturers to apply for PEPP authorisations, it would serve as a good opportunity for the ESAs to clarify that the default investment option of the PEPP (the basic PEPP) should be considered, by default, a non-complex product, and should be available to buy under the execution-only regime.

BETTER FINANCE puts forward this recommendation given the history and rationale behind the basic PEPP: an investment option that "*normally complements lack of knowledge, of understanding, indecision or passiveness of savers in making an investment*", which is necessary for any retirement provision system.[4] As such, the basic PEPP was designed as a simple, transparent, and safe investment option, reason for which it should be considered simple under EU law.

Integrate inflation in the risk assessment

Traditionally, risk in financial products (and, thus, complexity) is viewed through the lenses of volatility and magnitude of potential losses. While BETTER FINANCE does not contradict the approach, it firmly advises EU authorities to consider integrating inflation in the assessment of potential losses. This is because, while certain products may have low risk indicators - such as debt securities products, which were generally considered a safe investment – the reality in recent years has changed due to low interest rates and rising inflation levels.

In other words, while a product may seem safe in nominal net terms, after adjusting for inflation – short or long-term – it may be that it loses money for the beneficiary. A straightforward example can be a money market fund which, at a 1.5% average nominal net return – considering a modest 2% historical inflation rate – will surely generate losses for the beneficiary.

ESAs to better comply with the obligation to promote simplicity

The European Supervisory Authorities (ESMA, EIOPA, EBA) have a legal duty to promote simplicity, according to their founding Regulations (1093, 1094, 1095 of 2010), providing that: "*The Authority shall take a leading role in promoting transparency, simplicity and fairness in the market for consumer financial products or services across the internal market* (...)".

BETTER FINANCE strongly recommends for the ESAs to better comply with this essential EU law for retail financial services users in addition to promoting product simplicity, which should be added to their role: as a first step the ESAs should report annually on their actions to promote simplicity, like they do for their financial education efforts for example.

[4] See BETTER FINANCE's Response to EIOPA's Public Consultation on the PEPP: https://betterfinance.eu/publication/better-finance-response-to-eiopa-pepp-consultation/.

INTRODUCTION

In January 2019, BETTER FINANCE published its "Key Priorities for the Next Five Years"[5] that would go a long way towards improving the financial wellbeing of EU citizens and benefit the real economy, and that were well received by most European political groups. One of the key issues that BETTER FINANCE asked policymakers to address was "*Better access to simple and transparent products*". BETTER FINANCE advocated for a "direct access to simple investment products (such as equities, bonds, index ETFs and UCITS funds) that bring EU citizens as investors closer to real economy assets, instead of relegating them further into more packaged, complex, opaque and fee-laden products".

Retail savers are faced with a large array of financial services and products, which are becoming more diverse and innovative, but at the same time more complex and riskier.[6] While the participation rate of EU households in capital markets increased significantly throughout the first two years of the global health pandemic, the low level of trust in the financial system has not changed. As such, many non-professional savers are turning to "do-it-yourself" investing, which is done through execution-only services and involves no formal support from finance professionals as regards the instruments or markets to invest in.

To counteract the potential mis-selling of financial products, EU law imposed a system of safeguards to ensure that a financial instrument meets the knowledge, experience, and/or needs of a particular client.

This evaluation – the alignment of a product with a particular investor profile – awards different levels of investor protection, depending on the type of service chosen:

- *suitability assessment*, for advised services (investment advice);
- *appropriateness assessments*, for non-advised (selling) services;
- *product simplicity*, for execution-only services.

The differing levels of protection awarded through these evaluations have limited effects for non-professional investors and create a regulatory burden in the distribution process. The rules applicable for advising and selling EU retail financial product categories differ from one category to another.

Table 1. Distribution safeguards by type of product category

Service type	MiFID II	IDD	CCD	MCD	MiCA
Advised services	Suitability assessment	Suitability assessment	None	Suitability assessment	Suitability and appropriateness assessment
Non-advised services	Appropriateness test	Appropriateness test	None	Creditworthiness	None
Execution-only	Non-complex products	Demands & needs test, non-complex products	None	None	None

Source: BETTER FINANCE, 2021

Generally, financial advice is subject to a suitability assessment,[7] which is the strongest safeguard currently available to retail clients. This is because advisers are obliged to undertake a comprehensive analysis to determine whether a product is aligned with the financial situation, risk tolerance, knowledge, experience, and needs of a particular client.

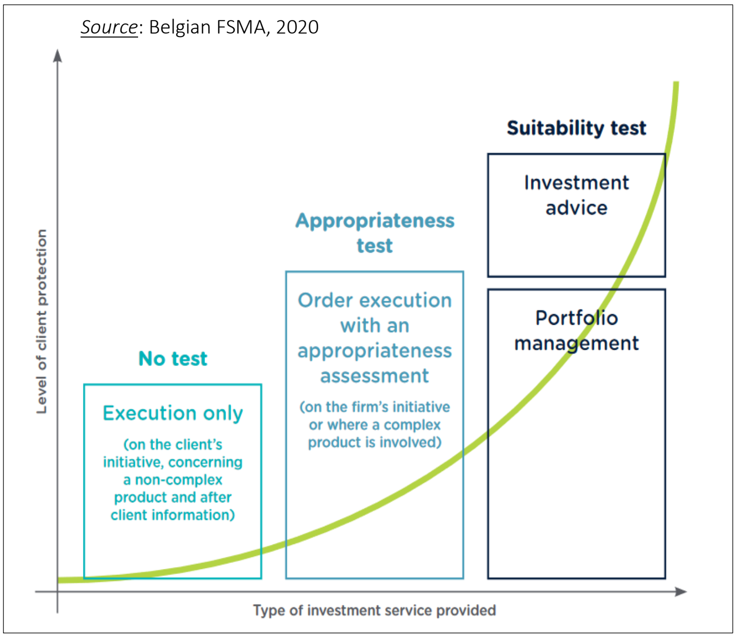
[5] See BETTER FINANCE Key Priorities for 2019-2024, available at: https://betterfinance.eu/publication/better-finance-key-priorities-for-the-next-five-years-%E2%94%82-2019-2024/.

[6] See also Jeremy Burke, Angela A. Hung, 'Trust and Financial Advice' (January 2015) RAND Working Paper WR-1075, 3, available at: https://www.rand.org/content/dam/rand/pubs/working_papers/WR1000/WR1075/RAND_WR1075.pdf.

[7] With the notable exception of consumer credits, for which no suitability evaluation is required.

Currently under debate within the European Parliament, the Regulation on markets in crypto-assets (MiCA) would set a new high threshold for investor protection through the *suitability and appropriateness assessment* that must be undertaken by advisers on crypto-assets. Under this evaluation, advice for crypto-assets must ensure that the instrument is aligned with the requirements, preferences, specific needs, risk tolerance, ability to bear losses, but also the knowledge and experience of the client.

The strongest element in the MiCA proposal is the prohibition to accept and retain commissions from crypto-asset issuers, which are the main culprits corrupting bias-free investment advice in financial markets.[8] The second type of distribution channel by type – selling - must be accompanied by an appropriateness test, which only evaluates whether a product is in line with the knowledge and experience of the client or prospective client. The same assessment must be made also for *execution-only services*, if the product is complex.



No evaluation is required for execution or reception and transmission of orders (*execution-only*), provided two criteria are met: first, the client must be informed by the services provider that he/she does not benefit from the protection awarded through the appropriateness assessment and, second, that no complex instruments are requested.

This framework[9] is replicated – although with some differences – for insurance-based investment products under the Insurance Distribution Directive (IDD[10]). The distinction is that, for execution-only services, insurance distributors (intermediaries or manufacturers) must undertake a *demands and needs* assessment besides the *complex products* limitation.

The differing levels of investor protection stemming from the suitability, appropriateness, and execution-only evaluations can be observed through the information requirements that intermediaries need to obtain from clients before performing the assessments, as described in the table below.

[8] See BETTER FINANCE's Evidence Paper on Inducements (January 2022) available at: https://betterfinance.eu/publication/better-finance-evidence-paper-on-the-detrimental-effects-of-inducements/.
[9] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, ELI: http://data.europa.eu/eli/dir/2014/65/oj.
[10] Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, ELI: http://data.europa.eu/eli/dir/2016/97/oj.

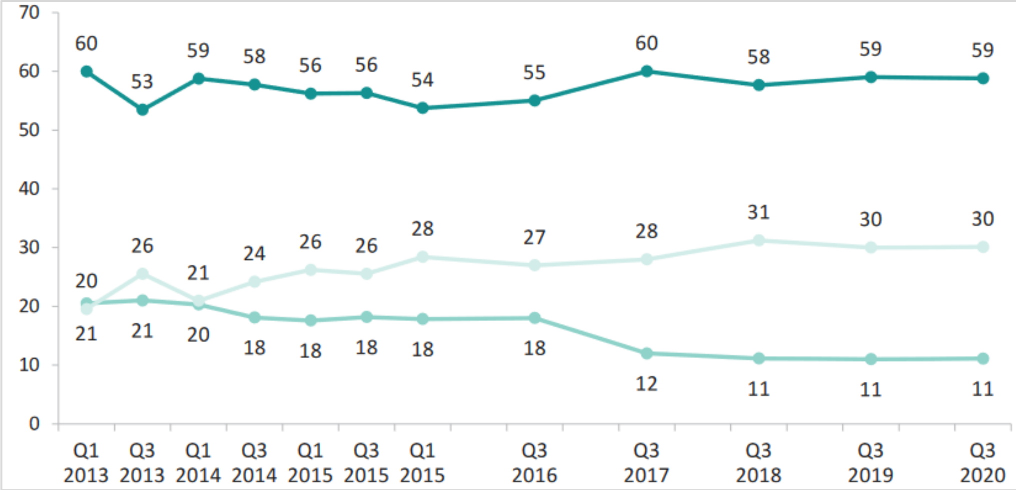
Table 2. Cross-sectoral analysis of information requirements in distribution channels			
Level	Suitability (advice)	Appropriateness (selling)	Execution-only
MiFID II Art. 25(2) Art. 25(3) Art. 25(4)	• knowledge and experience • financial situation (incl. ability to bear losses) • investment objectives (incl. risk tolerance)	• knowledge and experience	• no alignment test required; • not possible to sell complex products;
IDD Art. 30(1) Art. 30(2) Art. 30(3)	• knowledge and experience • financial situation (incl. ability to bear losses) • investment objectives (incl. risk tolerance)	• knowledge and experience	• demands and needs test; • not possible to sell complex products;
Mortgage credit Art. 22(3) Art. 20(1)	• personal and financial situation • preferences and objectives	• creditworthiness (income, expenses, other financial and economic circumstances);	No prescription
Crypto assets Art. 73 Art. 72	• requirements, preferences, specific situation; • risk tolerance, ability to bear losses;	No prescription	No prescription

Source: BETTER FINANCE, 2021

The younger generations are more oriented towards DIY ("do it yourself") investing – as research shows – and are attracted to new, digital investing platforms, such as neo brokers. Self-investing takes the form of execution-only services, which distinguish themselves from other investment services by the fact that the initiative comes exclusively from the client. In other words, there is no proposition, advertising, or pitching from distributors or product manufacturers of the financial products or services on offer. Investing through execution-only services is, on most occasions, similar to a *self-service* corner, which is becoming more and more mundane. One of the reasons for this evolution, as evidenced by BETTER FINANCE's research, is the forced digitalisation of services as a consequence of health-related lockdowns, which forced providers across consumer markets to develop tools that allow consumers to access services without human interaction. Although further research should confirm this finding, it seems that consumers have become less dependent on customer staff and more on digital tools.

At the same time, evidence from the Dutch supervisory authority (AFM) shows a long-term trend among the majority of Dutch investors of investing without formal support (advice or asset managers), reaching 59% by the end of 2020, a phenomenon that may have been triggered by the Dutch ban of inducements. In fact, in 2020 the European Commission commissioned a study on [11] "*Disclosure, Inducements and Suitability Rules for Retail Investors*" that will analyse the current rules in place regarding disclosure of information, inducements and suitability and "*shall provide policy-makers with the necessary data to carry this assessment and inform possible future policy actions*".

[11] See the European Commission's E-Tendering webpage: https://etendering.ted.europa.eu/cft/cft-display.html?cftId=5959.



Source: AFM 2020 report;[12] top line represents self-investing; middle line represents investing via an investment advisor and bottom line represents investing via an asset manager.

In addition, two other recent events shifted additional attention to execution-only services: the GameStop case of 2021, indicating that many retail investors actively engage on social networks and invest by themselves, as well as the crypto-investing trend, revealing the large number of non-professional investors attempting to make a profit via these new digital assets, without receiving formal support (advised or non-advised services).[13]

Therefore, we observe that *execution-only* services are growing in importance thanks to their popularity among retail savers and the new business models employing them. It thus becomes pivotal to reassess the safeguards embedded in EU law for non-professional savers in terms of execution-only services in order to better understand whether, and where, there would be a need for reform.

This paper will take a closer look at how EU law defines complexity (or simplicity) of financial instruments in the different sectoral frameworks. First, the report will analyse whether there is a disconnect between how complex investments are qualified and what they actually look like in practice.

Second, this report also analyses the benchmark used by EU law and the EU supervisors (ESMA and EIOPA) in defining the residual category of "*other*" simple (or non-complex) products, which is a strong reflection of how the aforementioned understand simple products in general. The last section of the report will summarise the findings of this research and put forward policy recommendations.

PRODUCT SIMPLICITY IN EU LAW

In securities markets, execution-only services are usually provided by brokerage houses or online brokerage platforms; of course, other financial firms (banks, asset managers, insurers) can provide execution-only services as well, but it is less usual.

EU law limits the array of instruments that the retail client can choose from to only *simple products* as a safeguard against mis-selling of financial instruments. EU law prohibits providers of execution-only services from performing transactions on behalf of clients if the product is complex; otherwise, the provider must ask the client for specific in order to perform an *appropriateness* evaluation – at the very least – and thus ensure that the product is appropriate.

Retail investors create brokerage or investment accounts and instruct the provider what transactions to perform (buy/sell) without any support or proposition from the latter.

[12] AFM Consumentenmonitor 2020 https://www.afm.nl/nl-nl/professionals/nieuws/2021/april/consumentenmonitor-beleggen-najaar-2020.

[13] Due to the fact that, up until recently, these assets – and potentially the ancillary services – were unregulated, creating an underserved market.

The manner in which products are defined as complex does not differ significantly between securities and insurance-based investments markets, but the "fine print" given by the EU supervisors, the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), does create an application gap between the two frameworks.

To begin with, we must first understand which types of investors are considered "retail" clients under MiFID II and IDD (securities and insurance markets).

Client categorisation – retail clients

The preliminary condition to arrive to the hypotheses described below – execution-only services with only non-complex products – is that the prospective investor is categorised as a *retail* client, i.e. a non-professional investor. The rules on client categorisation slightly differ from MiFID II to IDD but are generally built on the premise that non-professional ("retail") investors lack the necessary knowledge, financial literacy, and investing experience to understand the characteristics and risks of financial instruments and capital markets so as to be able to protect themselves and make informed decisions without the intervention of finance professionals acting in their best interests.

This is readily apparent, first, from the MiFID II rules on client categorisation, which specify that prospective investors will be considered as *retail* clients if they do not qualify, or do not opt to be treated, as professional clients, and vice-versa. To begin with, *professional clients* under MiFID II are all those who possess "*the experience, knowledge and expertise to make [their] own investment decisions and properly assess the risks that it incurs*", which are further exemplified as credit institutions (e.g., banks), investment firms, institutional investors, large undertakings, or public authorities.

However, MiFID II grants the possibility for any professional investor to be treated – on its own request – as a retail client and ask for a high standard of protection.

On the other hand, all retail investors can ask the investment firm to be treated as a *professional client*, provided that either two of the following conditions are met (Pt. II.1 of Annex II, MiFID II):

- *the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters,*
- *the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500 000,*
- *the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.*

The Insurance Distribution Directive does not differentiate between professional and retail customers. The only reference to what is understood by retail clients in insurance distribution is in Art. 22 on *information exemptions and flexibility clause*, which borrows the concepts of professional and retail clients from MiFID II.

Analysing the conditions under MiFID II for retail clients to be treated as professionals, *per a contrario*, we observe that the criteria distinguishing the two segments is trading experience and technical knowledge, but also the size of the investable amount. In our view, this contradicts the definition of a professional client provided in MiFID II, i.e., factors that enable the client to adequately understand the product, its functioning (features, costs, triggers, other clauses) and its risk-return profile.

MiFID II – securities markets

For securities markets the applicable framework is harmonised across EU27 Member States through MiFID II. According to the latter, *execution-only services* are those which only "*consist of execution or reception and transmission of client orders with or without ancillary services*" (Art. 25(4) MiFID II). As explained in the introduction, execution-only services are the lowest in the MiFID II hierarchy of retail investor safeguards, after non-advised (selling) services and advised services.

This third category of services is meant to provide a degree of flexibility and freedom for non-professional clients who may not wish or see the need to acquire additional (ancillary) services from investment firms, for instance investment advice.

MiFID II stipulates four requirements for the distribution of financial instruments through execution-only services:

- the client must have the initiative for such services;
- it must concern only *simple* products;
- the client must be clearly informed that he or she does not benefit of the protection awarded through the appropriateness evaluation;
- the provider must comply with conflict-of-interest rules (prevention, management and disclosure).

Regarding *simple* products, the EU legislators chose four categories of financial instruments that are considered, by default, simple (Art. 25(4)(a)(i)-(iv) MiFID II):

(i) shares admitted to trading on a regulated market or on an equivalent third-country market or on an MTF, where those are shares in companies, and excluding shares in non-UCITS collective investment undertakings and shares that embed a derivative;

This category comprises listed equities, such as simple shares in companies, including those from non-EU markets.

(ii) bonds or other forms of securitised debt admitted to trading on a regulated market or on an equivalent third country market or on a MTF, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;

This category comprises debt securities, such as public or corporate bonds, including those issued by entities from non-EU markets.

(iii) money-market instruments, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;

This category comprises currencies (foreign exchange) or commercial paper (short-term debt securities).

(iv) shares or units in UCITS, excluding structured UCITS as referred to in the second subparagraph of Article 36(1) of Regulation (EU) No 583/2010;

This category comprises traditional mutual investment funds (UCITS), but not AIFs or any of its sub-categories (ELTIFs, SPACs).

(v) structured deposits, excluding those that incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term;

Structured deposits are a combination of term deposits and investments: the deposit can be withdrawn at maturity, in addition to which the deponent receives the profits from the underlying investment, if any.

(vi) other non-complex financial instruments for the purpose of this paragraph.

The MiFID II approach (replicated in IDD as well, see IDD section) is to define complex products by excluding non-complex ones. To enable regulatory flexibility in light of product innovation, MiFID II provided for a residual category of "*other non-complex financial instruments*" (Art. 25(4)(a)(vi) MiFID II), which was left for the European Commission and ESMA to clarify. In this sense, the Delegated Regulation (2017/653) specifies the content of the *other non-complex financial instruments* category. The first range of products considered by default complex are those transferable securities that give "*the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures*". In other words, the derivative contracts listed in pts. (4)-(11) in Section C of Annex I of MiFID II.

As opposed to traditional investments, where the return is the actual increase/decrease in value of the asset (security) held, derivatives' returns are artificial as they are calculated – in a wide variety of ways – based on the return of a reference asset (security).

Derivative contracts are by nature considered complex due to their functioning and increased risk. With traditional instruments (such as equities, bonds, investment funds) the loss is limited to the total amount invested (-100%); in contrast, many derivative contracts have an unlimited loss potential, meaning that these can further indebt the investor. For instance, leveraged contracts for difference on major currency pairs (USD/EUR) were banned altogether by ESMA in 2018 for leverage ratios above 30:1.[14]

In addition, the Commission Regulation (2017/565) provides other four cumulative criteria for the assessment of other non-complex instruments:

- *there are frequent opportunities to dispose of, redeem, or otherwise realise that instrument at prices that are publicly available to market participants and that are either market prices or prices made available, or validated, by valuation systems independent of the issuer;*

This condition means that the investor can easily (frequently) monitor the prices and can easily sell back the instrument (redeem it).

- *it does not involve any actual or potential liability for the client that exceeds the cost of acquiring the instrument;*

This means that the investor's losses should not exceed his investment.

- *it does not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay out profile, such as investments that incorporate a right to convert the instrument into a different investment;*

This means that the instrument or any of its features should not be convertible, such as a call option to buy a share at a strike price.

- *it does not include any explicit or implicit exit charges that have the effect of making the investment illiquid even though there are technically frequent opportunities to dispose of, redeem or otherwise realise it;*

For instance, the instrument has a very high offload fee before maturity, making it difficult for the client to redeem it.

- *adequately comprehensive information on its characteristics is publicly available and is likely to be readily understood so as to enable the average retail client to make an informed judgment as to whether to enter into a transaction in that instrument.*

Proper explanations are provided on material disseminated to potential clients or on durable mediums, such as a website.

In our view, these criteria listed in Art. 57 of Regulation EU 2017/565 describe, in fact, the characteristics of derivative contracts and structured products, with the exception of the last point. In our view, the likelihood of such information to be understood by the "*average retail client*" in order to make an "*informed judgment*" defeats the purpose of all other safeguards. We believe that the reason behind prohibiting the sale without a suitability or appropriateness assessment of complex products derives from the specificity and technicality of their functioning and risk exposure, which is highly unlikely to be adequately understood even by more experienced non-professional investors.

Therefore, requiring disclosures – either as marketing communication material or regulatory documents – to be comprehensive and enable the average retail client to make an informed judgment, contradicts the safeguard of execution-only services.

In addition to the *simple product* criterion, investment firms must clearly inform the client that, under execution-only services, he or she will not benefit of the additional safeguards awarded under non-advised and advised services (Art. 25(2) and (3) MiFID II), respectively *appropriateness* or *suitability assessment,* and must still abide by the rules on conflicts of interests (Art. 23 MiFID II).

[14] European Securities and Markets Authority, *Press Release: ESMA Agrees to Prohibit Binary Options and CFDs to Protect Retail Investors* (27 March 2018) ESMA71-98-128, available at: https://www.esma.europa.eu/press-news/esma-news/esma-agrees-prohibit-binary-options-and-restrict-cfds-protect-retail-investors.

PRIIPs regime – comprehension alert

A new element, situated between conduct of business, investor protection, and disclosure rules, is introduced by the PRIIPs Regulation.[15] The latter lays down the rules for pre-contractual disclosures of retail investment products (*key information documents*), which cover both MiFID II and IDD-regulated products.[16] Before being sold to consumers, packaged retail and insurance-based investment products (PRIIPs) are accompanied by a disclosure document which explains the nature of the investment, time horizon, risk profile, cost, estimated returns, etc.

However, the PRIIPs regime requires manufacturers to include a *comprehension alert* in the disclosure document for PRIIPs warning consumer that "*You are about to purchase a product that is not simple and may be difficult to understand*" (Art. 8(3)(b) PRIIPs Regulation).

The PRIIPs Regulation does not further qualify what a simple product is and what is the comprehension level that should be taken into account by manufacturers when determining whether the PRIIP would or wouldn't be "*difficult to understand*". The only indication of what was meant by the precited provision comes from the Recitals of the PRIIPs Regulation. According to Recital (18), a product is not simple and easy to understand if:

- "*it invests in underlying assets in which retail investors do not commonly invest*",
- "*it uses a number of different mechanisms to calculate the final return of the investment, creating a greater risk of misunderstanding on the part of the retail investor*" or
- "*the investment's pay-off takes advantage of retail investor's behavioural biases, such as a teaser rate followed by a much higher floating conditional rate, or an iterative formula.*

This approach is fairly different to the established MiFID II and IDD product simplicity doctrine. However, the European Commission reversed this approach when fine-tuning the details of the PRIIPs Regulation: in the implementing law (2017/653), it is specified that products will display a comprehension alert when the former do not qualify as simple products under their respective frameworks (MiFID II and IDD). In our view, there are two issues:

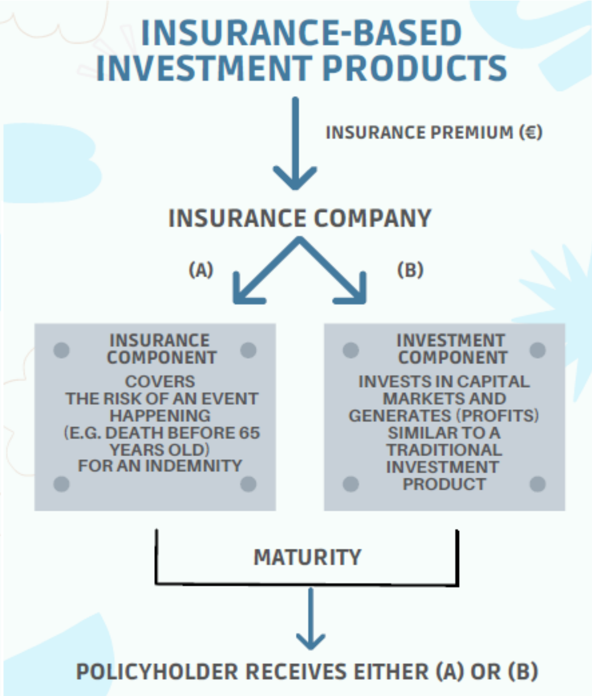
- the PRIIPs regime does not regulate investment products, but only specifies the content of their disclosure documents;
    - in other words, a PRIIP is not a new or distinct product, but a larger category of investment products, which means that a PRIIP sub-category continues to be regulated by its sectoral legislation;
    - therefore, it follows that a simple PRIIP is that which is simple under MiFID II or IDD;
- the European Commission is confined to the delegation power provided in the PRIIPs Regulation, but most importantly it must be guided by the spirit of the regulation and the intent of the co-legislators, which means that the implementing provision should have, in fact, replicated the three criteria listed in Recital (18).

Nevertheless, in our view the PRIIPs regime complements the simple product doctrine of MiFID II and IDD with the three new categories specified in Recital (18), meaning that EU and national supervisory authorities should take into account the aforementioned when reviewing the product simplicity doctrine.

[15] Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).
[16] However, to date the PRIIPs regime does not apply to UCITS and, in some jurisdictions, AIFs.

IDD – insurance-based investment products

The European Insurance and Occupational Pensions Authority (EIOPA) observed in its most recent Consumer Trends Report (2021)[17] a decrease in safer and simpler *profit participation* insurance-based investment products (IBIPs) in favour of the more complex and riskier unit-linked insurances and hybrid products (those with lower guarantees and higher return opportunities).



Source: BETTER FINANCE, 2021

While EIOPA explains that the shift away from products with higher guarantees may be a consequence of the low-yield environment, making it more difficult for insurers to offer attractive return opportunities for policyholders, the evolving market environment raises the question of the changing complexity landscape of insurance-based investment products. In other words, the search for attractive potential returns in life-insurances for consumers may generate more complex and riskier products advised or offered to consumers.

Thus, the question is whether the EU framework defining simple (*per a contrario* complex) insurance-based investment products is fit-for-purpose.

As explained above, product complexity must take into account the EU co-legislators' intent from the PRIIPs comprehension alert. All other aspects being equal, it is important to analyse how the IDD framework builds on the product simplicity doctrine of MiFID II and extends to the residual category of *other* simple products.

To begin with, the Insurance Distribution Directive (IDD) follows the MiFID II model and allows insurance intermediaries to distribute insurance products, including IBIPs, under *execution-only services* without a suitability or appropriateness assessment if the products are simple ***and*** aligned with the customer's "*demands and needs*" (Art. 20(1) IDD). We note that the latter requirement is an additional safeguard in comparison to MiFID II.

Second, IDD describes *simple products* first based on MiFID II's requirements: all those products that provide investment exposure to products that are simple under MiFID II (Art. 30(3)(a)(i) IDD). Here, the analysis provided in the section for MiFID II stands.

Further, there may be other products (IBIPs) that can be considered as non-complex, provided under the residual category of "*other non-complex insurance-based investment products*" (Art. 30(3)(a)(ii) IDD). Since IDD does not provide further guidance, it was left for the European Commission and EIOPA to clarify what products fall under this residual category. In the Delegated Regulation for IBIPs (Regulation 2017/2359), the European Commission specified that the *other* non-complex products will be those that satisfy **cumulatively** all following criteria:

[17] European Insurance and Occupational Pensions Authority (EIOPA), 2021 Consumer Trends Report (2021) available at: https://www.eiopa.europa.eu/document-library/consumer-trends-report/consumer-trends-report-2021_en.

(a) include "*a contractually guaranteed minimum maturity value which is at least the amount paid by the customer after deduction of legitimate costs*";

A product with such a feature can be, for instance, a capital guaranteed life-insurance.

(b) do "*not incorporate a clause, condition or trigger that allows the insurance undertaking to materially alter the nature, risk, or pay-out profile of the insurance-based investment product";*

This category comprises classical life insurances with guaranteed minimum interest rates on investment parts of premium (investments made by the insurer itself).

(c) provide "*options to surrender or otherwise realise the insurance-based investment product at a value that is available to the customer*";

In theory, where the returns of the product and underlying options are publicly available (such as on the website of the insurer).

Note*: However, in practice, the actual evolution of the product as a whole is generally not available since only the insurance company knows what amounts of the gross insurance premium(s) have been allocated to which investments and, thus, the customer must inquire with the manufacturer in order to obtain the actual profit or loss on the investment component.*

(d) do "*not include any explicit or implicit charges which have the effect that, even though there are technically options to surrender or otherwise realise the insurance-based investment product, doing so may cause unreasonable detriment to the customer because the charges are disproportionate to the cost to the insurance undertaking*";

This criterion comprises, for instance, those insurance-based investment products that have low or no exit fees or otherwise low charges for surrendering the contract before the stated maturity term.

Note*: This requirement is generally not met for many examples of life insurance contracts. The reason is that penalty charges for early cancellation are not disclosed in advance. There are indications in the key information document (KID) and in the terms and conditions of the contract that these charges exist, but neither the amount, nor the way in which they are calculated are disclosed in advance. Additionally, distribution costs (mainly commissions at the beginning of the contract duration) strongly reduce the investment part of the gross premium, and in case of cancellation these are not reimbursed to the customer.*

(e) do "*not in any other way incorporate a structure which makes it difficult for the customer to understand the risks involved*".

This criterion is analysed below (EIOPA Guidelines).

The EIOPA Guidelines on complex products saw the need to reconcile the "*significant overlap in the provisions that apply in the case of Article 30(3)(a)(i) and those that apply in the case of Article 30(3)(a)(ii) of IDD*". As such, it adopted three guidelines for the *other non-complex IBIPs*, notably:

- *Contractual features concerning the determination of the maturity or surrender value or pay out upon death (guideline 6);*

Here, EIOPA highlighted that if such mechanisms are based on national law provisions aimed at ensuring or specifically safeguarding the interests of consumers, such contracts should not be subject to particular assessments by insurance providers in light of their complexity. In all other cases, EIOPA noted that there are four features which could make the structure of the contract difficult to understand by consumers:

(a) the maturity or surrender value or pay out upon death is dependent on variables set by the insurance undertaking, the effects of which are difficult for the customer to understand;
(b) the maturity or surrender value or pay out upon death is based on different types of investment exposures or strategies the combined effect of which are difficult for the customer to understand;
(d) the maturity or surrender value or pay out upon death may vary frequently or markedly at different points of time over the duration of the contract either because certain pre-determined threshold conditions are met or because certain time-points are reached. This does not include changes in the maturity or surrender value or pay out on death due to the payment of discretionary bonuses;

(c) there is a guaranteed maturity or surrender value or pay out upon death that is subject to conditions or time limitations the effects of which are difficult for the customer to understand. This does not include changes in the guaranteed maturity or surrender value or pay out upon death due to the payment of discretionary bonuses.

- *Contractual features concerning costs (guideline 7);*

The cost structure, in particular what types of charges are applied under different scenarios or actions taken by the policyholder, can determine the complex structure of an IBIP. EIOPA recommended for insurance providers to "*assess whether the costs are not likely to be readily understood by the customer, in particular the conditions under which the costs can change significantly during the duration of the contract, including based on the performance of the investment*".

The same limitation as for guideline 6 is used for the complex cost structure under guideline 7: if the cost structure stems from duties under national law specifically aimed at protecting the interests of consumers, then such structure should not be considered an element that makes the contract difficult to understand by consumers.

- *Contractual features concerning the beneficiary of the insurance contract (guideline 8);*

This guideline concerns the wording and/or criteria to identify the insurance-component beneficiary in an IBIP. In short, EIOPA underlined to product manufacturer that an IBIP will be considered complex if "*there are contractual provisions allowing the customer to use a nonstandard wording to define the person receiving the benefits at the end of the contractual relationship (beneficiary clause) which can lead to difficulties to identify the beneficiary and may result in difficulties for the beneficiary to effectively receive the pay out when the policyholder dies*".

Furthermore, in a public consultation on retail investor protection topics (ended in February 2022), EIOPA produced an assessment in which it identified three different dimensions that can contribute to complexity in IBIPs:

- level of market or counterparty risk
- level of complexity of the underlying features or operation of the product; and
- difficulty of understanding of the product by the average customer.

So, it seems that – in EIOPA's understanding of product complexity – the level of risk forms an integral part of complex or non-complex products.

EXAMPLES FROM BETTER FINANCE RESEARCH

The BETTER FINANCE research team undertook a mystery shopping exercise looking into several representative EU-based brokerage platforms that offer execution-only services. The accounts are real and belong to BETTER FINANCE team members, which have been qualified as "retail" clients, and no instruments were bought. However, we searched what type of instruments are available for "non-professional" investors from the point of view of *simple* vs *complex* products, in light of the abovementioned explanations.

Derivatives available on execution-only platforms

On brokerage platforms that offer MiFID II-regulated instruments, we found a couple of examples that raise questions in terms of their qualification as complex or non-complex instruments.

Warrants and options. The BETTER FINANCE team was allowed[18] to buy share options from a corporate issuer trading on the US market and one on an EU-based market. The instruments, a "European"-style call option and an "American"-style call warrant, give the right to the acquiror to buy the underlying share at a strike price at a future date or before a future date, respectively, in exchange of a payment (premium).

A warrant is a variation of an option with the difference that, if the investor exercises the right (*calls*) and buys the underlying (e.g., share), the company must issue a new share for it, whereas with a call option the underlying (e.g., share) already exists.

The second instrument (call warrant on US stock) was accompanied by the following warning (translated in English): "*You wish to make an order as part of execution-only on a non-complex financial instrument. Please note that* [broker] *does not have to assess beforehand whether this instrument is suitable or appropriate for you*". The first instrument (call option) only required the client (mystery shopper) to tick a box that he/she has read the KID (key information document) and acknowledges the costs relative to the service and to the product detailed in the KID.

In the KID (which is designed and made available only for "retail" investors), the product manufacturer described the intended market ("*the type of retail investor to whom the PRIIP is intended to be marketed*" – Art. 8(3)(c)(iii) PRIIPs Regulation) is for investors with extensive knowledge and/or experience in financial products and financial markets. The product has a 5 out of 7 risk profile (between medium and high risk), although losses (in the stress scenario) can go up to -73% of the investment.

"Bermuda"-style turbo. The research team was also able to find and buy "turbos" with EU-based corporate issuers (shares) as underlying. The instrument is a 5:1 (five-to-one) leveraged call warrant which gives the acquiror the right to buy (*call*) the underlying share at a pre-agreed price (strike) only on a pre-specified date.

The difference between the *turbo* and the *warrant/options* lies in its leverage (the fact that the investor also takes a credit from the product manufacturer which is further invested) and in the possibility to call (buy) the underlying asset.

Leverage, or *leveraged* product, means that the investor borrows as many times-to-one (x:1) its own investment in order to purchase the product; e.g., the client has €100 to invest, then in a 5:1 (five-to-one) leveraged product the client actually invests €600, of which €500 are loaned and owed to the product manufacturer.

According to the Key Information Document (KID) the research team found for the product, the product is intended for clients that have "*an advanced knowledge and/or experience with financial products and markets*". The product is very risky, with a 7 out of 7 risk scale, with potential losses in 3 out of four performance scenarios (even the moderate one), and barely a +1.33% net return in the favourable one. However, the product is very short term, with a one day recommended holding period.

In this sense, we note that the PRIIPs regime for calculating performance scenarios does not specify to deduct and report the win or loss in relation to the leveraged amount. In other words, the potential -42.50% loss in the stress scenario for the turbo does not concern the paid amount by the investor (e.g. €100), but the total leveraged amount (e.g. €600), which means that the loss for the retail client would be, in fact six times higher, or -345%. In fact, according to the PRIIPs implementing Regulation (EU 2017/653), a risk class of 7 out of 7 for derivative contracts is qualitative – not quantitative – and it means that there is the risk of losing more than the invested amount (pt. 4(a) of Annex II).

Moreover, and unfortunately, the KID does not mention what leverage ratio the product has, only that it has a ratio: the client would need to read the Prospectus and the Final Terms applicable to the contract to learn these conditions.

[18] But, as highlighted above, did not proceed.

The research team also found a zero-commission brokerage platform that allows retail clients to buy contracts for difference (CFDs)[19] in 10 EU Member States[20] under an execution-only regime.[21] What is striking is that the platform warns clients that 61% of investors lose money when investing in such instruments.

Auto-callable bonds. The research team found an auto-callable bond designed for retail investors which comprises a comprehension alert according to the PRIIPs regime. The product offers the buyer a call option (possibility to buy) of an underlying bond index which offers complete (nominal) capital protection at maturity, when the return of the product will be that of the underlying index, or otherwise it will be automatically called (bought) under pre-defined conditions, before the maturity of the contract. Looking at the intended retail client, the product's KID specifies it is intended for those that have specific knowledge and experience with similar products, and that have the ability to understand the products, its risks and benefits, and particularly that understand that the capital protection is only applicable if the product reaches maturity.

In this sense, we note that this is one of the clearest explanations for the intended retail client across all PRIIPs KIDs that the research team has analysed – it clearly sets out what type of knowledge and understanding the client must have in order to make an informed decision about the product.

In terms of risk, we observed that it was calculated as having almost the lowest risk-class under the PRIIPs regime (2 out of 7), especially since it offers capital protection if the conditions for the automatic call (buy – exercise) are not met before the maturity of the product.

Alternative Investment Funds

As highlighted in the section about MiFID II above, only units or shares in UCITS (EU-labelled mutual investment funds that can be sold across borders) can be sold to retail clients without a prior suitability or appropriateness assessment. However, in many jurisdictions (such as France) they are distributed to retail investors as ordinary investments.

A typical alternative investment fund sold to retail clients will have a pre-contractual disclosure document (KIID or KID, depending on the jurisdiction) and will follow a similar pattern to a UCITS or other pooled investment vehicle. What distinguishes alternative investment funds from UCITS are the lower thresholds, or higher flexibility, of management and investment universe. For instance, AIFs allow investments into more illiquid or riskier assets than UCITS (such as private equity, real estate etc).

The majority of AIFs are very similar in their structure or functioning to UCITS but are delimited to the increased market or counterparty risk to which they offer exposure. Thus, given that the purpose of the *non-complex regime* is to ensure that the products offered are understandable to retail clients, BETTER FINANCE does not see a justification – for the majority of AIFs – to be considered complex.

For instance, a particular kind of AIF are the European Long-Term Investment Funds (ELTIFs), which are not necessarily, in BETTER FINANCE's view, complex investments. Based on the research undertaken for its ELTIF report in 2020,[22] the research team analysed several key information documents (KIDs) of ELTIFs marketed to retail investors. In our view, the functioning and structure of the ELTIFs identified were not of such nature as to be difficult to understand by the average retail investor and pre-empt

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[19] According to ESMA, Contracts for Difference (CFDs) are agreements "*between a 'buyer' and a 'seller' to exchange the difference between the current price of an underlying asset (shares, currencies, commodities, indices, etc.) and its price when the contract is closed*" – ESMA, *Investor Warning: Contracts For Difference* (28 February 2013), p. 2, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-267.pdf.

[20] The same platform does not offer such services in the Netherlands, Germany, Spain, Austria, France, Ireland and Belgium, where – based on our information – derivatives are not available for retail investors.

[21] This is based on the reading of the Terms and Conditions which specify that the platform does not offer investment advice, does not evaluate the suitability of the products, and the customer is solely responsible for verifying whether the CFD is suitable for his/her profile.

[22] BETTER FINANCE, *Obstacles to the Development of an EU ELTIF Market* (December 2020), available at: https://betterfinance.eu/wp-content/uploads/BETTER-FINANCE-ELTIF-Research-and-Policy-Report-final-09122020.pdf.

them from taking an informed decision. As mentioned above, the difference lies in the riskier assets, longer time horizons, or limited liquidity (since these are long-term capital commitments).

A different example that the research team found are funds of funds which are, in most cases, riskier than a simple UCITS, but not necessarily complex so as to not be understood by the average retail investor. For instance, we found an example of an actively managed fund, without reference to a benchmark, that channels capital to sub-funds investing in alternative (private equity projects). Looking at the Key Investor Information Document (KIID), the research team concluded that the objective, cost, and past performance information for this fund are sufficiently intelligible so as to be understood by the average retail client.

IBIPs

As noted by EIOPA in the most recent Consumer Trends Report (2021 edition), IBIPs are becoming more complex, notably due to the shifting of capital and investment risks towards consumers. At the same time, IBIPs are not often sold under execution-only services, which is most probably due to regulatory limitations: so far, the research team did not find platforms that provide access to such services, and the rest (for instance, where the consumer calls the agent or directly asks to subscribe to an IBIP) is difficult to evaluate.

The exercise is, therefore, limited to analysing a few examples of IBIPs that are considered complex under IDD but do not have a comprehension alert under PRIIPs, which could be an indication that these are sold without a suitability or appropriateness assessment. Nevertheless, it is worthwhile mentioning that, even under the execution-only regime, manufacturers and distributors must still assess whether the product meets the *demands and needs* of the customer.

IBIP with comprehension alert. The research team found a multi-option unit-linked life insurance contract offering the flexibility for multiple contributions in four types of funds and is intended for **any** non-professional investor, albeit the risk profile of this product ranges between the minimum and maximum (on the scale from 1 to 7).

The actual risk profile of the contract depends on the choice of underlying investments and the costs range from 0% to almost 7% (annually) by the end of the recommended holding period. The recommended holding period is by default fixed at 30 years, with a minimum recommended holding period of 8 years. Looking at the detailed cost section, the research team did not understand the link between the one-off and ongoing charges and the reduction-in-yield (summary cost indicator). To conclude, this is indeed a very complicated product to understand, even when just looking at the basic characteristics of the product (risk, cost, estimated returns).

IBIP without a comprehension alert. The research team found another multi-option product, particularly unit-linked life insurance with a single contribution which offers the possibility for the customer to choose among a range of investment funds as the underlying supports to invest. The structure of the product is very similar to the one with comprehension alert, yet the manufacturer did not include a comprehension alert: the risk scale ranges from 1 (minimum) to 6 on (out of 7, which is the maximum), and the underlying options range from bond, equity, and mixed allocation funds, including the possibility to invest in a profit participation fund which offers an element of capital guarantee.

The target market of the fund (intended retail investor) does not concern more experienced or knowledgeable investors; however, the research team found there may be an inconsistency between the type of retail clients described and the potential risk profile of the product. In particular, the product provides long term capital growth, for a risk-return profile that is above a traditional savings account which, in our view, does not capture adequately the potential volatility and risk of loss described by the higher side of the risk scale (5 and 6 out of 7).

Judging the two products side-by-side, the research team sees no significant difference in the structure, risk, or functioning of the two unit-linked insurances, yet one comprises a comprehension alert (potentially indicating that it may be considered complex) whereas the other is considered simple by default.

ANALYSIS & DISCUSSION

In this section, we aim to compare the theoretical analysis and the practical findings of our mystery shopping exercise side-by-side to better understand what overlaps or inconsistencies there are between the regulatory framework and its practical implementation.

Risk as part of product complexity

Our analysis on the applicable frameworks (level 1 and 2 regulations) and the European Supervisory Authorities (ESMA, EIOPA) guidelines point to the finding that product complexity is mainly based on the likelihood of the average retail client understanding the product and making an informed investment decision. However, the risk exposure (market, counterparty, liquidity risk) forms an integral and important component of how EU law understands and defines product complexity.

Thus, it begs the question as to whether risk should remain a factor defining product complexity or not, and the kind of investor protection objectives such a choice would entail.

We start our analysis on the basis of the client categorisation rules, particularly on how retail clients are distinguished from professional clients. Under MiFID II, a professional client is one who "*possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs*" (Annex II of MiFID II). As such, the quality of "retail" is based on the ability to independently analyse and make an investment decision, which hinges on knowledge, experience, and understanding of capital markets. Article 4(10) and (11) of MiFID II establishes that all clients are "retail", with the exception of those who satisfy the criteria in Annex II of MiFID II.

Furthermore, a "retail" client can request to be treated as a professional client, provided that either two of the following three criteria are met (fitness test):

- relevant trading experience ("*the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters*");
- investable assets or size of the portfolio ("*the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500 000*");
- professional experience ("*the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged*").

The first and third criteria relate to knowledge and understanding of financial instruments, transactions, and functioning of financial markets. As such the element defining non-professional investors is the limited literacy and ability to grasp the functioning and consequences of an investment decision. In other words, a non-professional investor is considered to not always be able to factor in the risk of losses, nor the loss absorption capacity, of financial transactions and instruments.

To compensate for this disadvantage, EU law imposes several safeguard systems in the distribution of financial products, as explained throughout this paper. In essence, if the product is too complex to protect the average investor from making errors, these must be sold with the guidance of a professional who can draw the attention to, and warn the investor of, all risks involved, besides choosing a product that is optimally aligned with the needs of the client.

Nevertheless, the investor can still override the suitability or appropriateness recommendation of the financial professional (express possibility both under MiFID II and IDD) and buy a product of his choosing (provided it is available from the distributor). This means that risk exposure is not a criterion *sine qua* *non* for protecting retail investors, but rather the likelihood that the client does understand, what the product entails, and assumes the risks.

In light of our research, we concluded that several examples of complex products that are easier to understand than non-complex products– as EU law defines them – can be found but are not sold under execution-only regimes due to their particular risk profiles (e.g., the possibility of losing more than the amount invested and incur liabilities indefinitely).

In other words, it seems that EU law at times confuses the ability of the retail client to understand the product functioning, costs, and other applicable features, with the capacity to understand the risk-return profile of the product or its underlying asset. Protecting retail clients against mis-selling, in particular of very risky products (such as CFDs), is an important pillar of investor protection, but not necessarily part of product complexity as it is currently understood.

As such, BETTER FINANCE finds that those elements defining a complex product that solely factor in the product risk should not be part of the complexity regime or, if these are kept, then an additional criterion determining *toxic products* should be included.

The question on one-off assessments

BETTER FINANCE's research found instances where brokerage platforms undertook a suitability assessment before opening the account, on the basis of which the client is granted access (without any further assessments) to a wide array of financial instruments, including derivative contracts. This prompted the question of whether an inception suitability or appropriateness assessment (even if reviewed on an annual or bi-annual basis) suffices to satisfy the conditions under Art. 25 MiFID II or Art. 30 IDD. In other words, do the *suitability* or *appropriateness* assessments have to be undertaken at every instance a client intends to perform a financial transaction (buy or sell financial instruments)?

To begin with, the aforementioned provisions are not sufficiently clear as to whether the assessment can be one-off or not: the obligation (both under MiFID II and IDD) is to gather sufficient knowledge about the client's situation so as to recommend or sell instruments that are suitable or appropriate. However, under MiFID II, the investment firm (for advised services) must submit a suitability report ("*statement on suitability*") to the client in which the investment recommendation is detailed and accompanied by an explanation of how the recommendation meets the "*preferences, objectives, and characteristics of the client*" (Art. 25(6) MiFID II). The same provision (and wording) is found under IDD for investment advice (Art. 30(5) IDD). According to the ESMA guidelines, these reports must be personalised, i.e. investment firms are not allowed to "*use a tick-the-box approach and/or generalizing phrases*"[23] when drafting the suitability report for the client (Question & Answer 10 under suitability of the ESMA Q&As on MiFID and MiFIR investor protection topics).

For the other services (non-advised and execution-only sales), neither MiFID II nor IDD provide for an *appropriateness report*, but do specify that the services provider must report recurrently on the services provided: "*The investment firm shall provide the client with adequate reports on the service provided in a durable medium. Those reports shall include periodic communications to clients, taking into account the type and the complexity of financial instruments involved and the nature of the service provided to the client*" (Art. 25(5) MiFID II and Art. 30(4) IDD). In addition, Art. 20(1) IDD specifies that any investment service provided by insurers to policyholders must be accompanied by a demands & needs test.

Analysing the follow-up requirements on the suitability and appropriateness assessment, we conclude that the MiFID II and IDD rules on these topics should be understood as requiring financial services providers to undertake a suitability or appropriateness (and demands & needs test) for every transaction or service provided to the client. In other words, BETTER FINANCE's view is that the

[23] European Securities and Markets Authority, *Questions & Answers on MiFID II and MiFIR investor protection and intermediaries topics* (ESMA35-43-349) last updated 19 November 2021.

regulatory framework does not allow for general suitability and appropriateness assessments on the basis of which the client can buy any range of instruments within a given period of time, even if reviewed or updated regularly. This opinion seems to be shared by the European Commission which noted – on the occasion of a public consultation concerning the *suitability and appropriateness* rules – that the current regime follows a "*per product*" approach, rather than a global (framework-based) one.[24]

Can PEPPs be sold under-execution only?

In 2019, EU law created a new category of personal pension products (individual, voluntary) that will bring a series of benefits for EU citizens, most importantly for those that work and save for retirement in different EU jurisdictions along their vesting stage.

The pan-European Personal Pension product (PEPP)[25] is a "a long-term savings personal pension product", subscribed under a PEPP contract either with a financial undertaking or an independent PEPP saver association (Art. 2(2) PEPP Regulation). In light of the upcoming official launch (start of the application of the PEPP Regulation) of PEPPs in several jurisdictions of the EU (22 March 2022), BETTER FINANCE believes it to be worthwhile to better understand the nature of the PEPPs and whether these could be subscribed to by EU citizens under execution-only services or not.

To begin with, the question regarding the PEPP is whether it should be seen as a standalone product – demanding its own rules and understanding of product complexity – or whether the PEPP will take the features of other EU-regulated products, for which the sectoral rules on complexity should be simply extended.

As highlighted above, the PEPP is a retirement provision vehicle that neither qualifies as a statutory (pillar 1, or State) pension, nor as an occupational (pillar 2, employee-related) pension plan. In other words, the PEPP is what in most pension systems is called a *voluntary, individual*, or *pillar 3* pension product (Art. 2(1)(c) read in conjunction with Art. 2(2) PEPP Regulation). Furthermore, a PEPP can be subscribed with several financial product manufacturers listed in Art. 6(1) of the PEPP Regulation (*simplified*), i.e.: credit institutions, insurance companies, IORPs (EU-labelled company pension plans), investment firms (such as asset managers), or alternative fund managers (AIFMs).

Thus, it appears that the PEPP is meant to provide common rules for all financial products aimed at retirement provision that are produced and distributed by the different product manufacturers under EU law. For instance, if a bank creates a term deposit with the purpose of capital growth for pension and an asset manager creates a life-cycle fund with the same objective, the PEPP regulation allows both products to be circulated under the PEPP label and benefit of certain passporting rights, provided that both products meet certain characteristics.

In addition, Art. 3 of the PEPP Regulation clarifies the hierarchy of rules applicable to PEPPs: primarily, PEPPs are regulated by the PEPP regulation, and will be subject to sectoral legislation (depending on the underlying type of financial product) in all matters not covered by the PEPP Regulation. From this analysis, BETTER FINANCE concludes that a PEPP is an umbrella label for different pension saving products and will follow the distribution rules, including the execution-only regime, of its underlying product type.

For instance, as it currently stands, a PEPP based on an alternative investment fund cannot be sold under the execution-only regime since it will be considered a complex product. Nevertheless, the PEPP Regulation obliges any manufacturer to make at least two options under each PEPP product available:

- the basic PEPP (default option)
- a tailored investment, depending on each product manufacturer (Art. 42(2) PEPP Regulation).

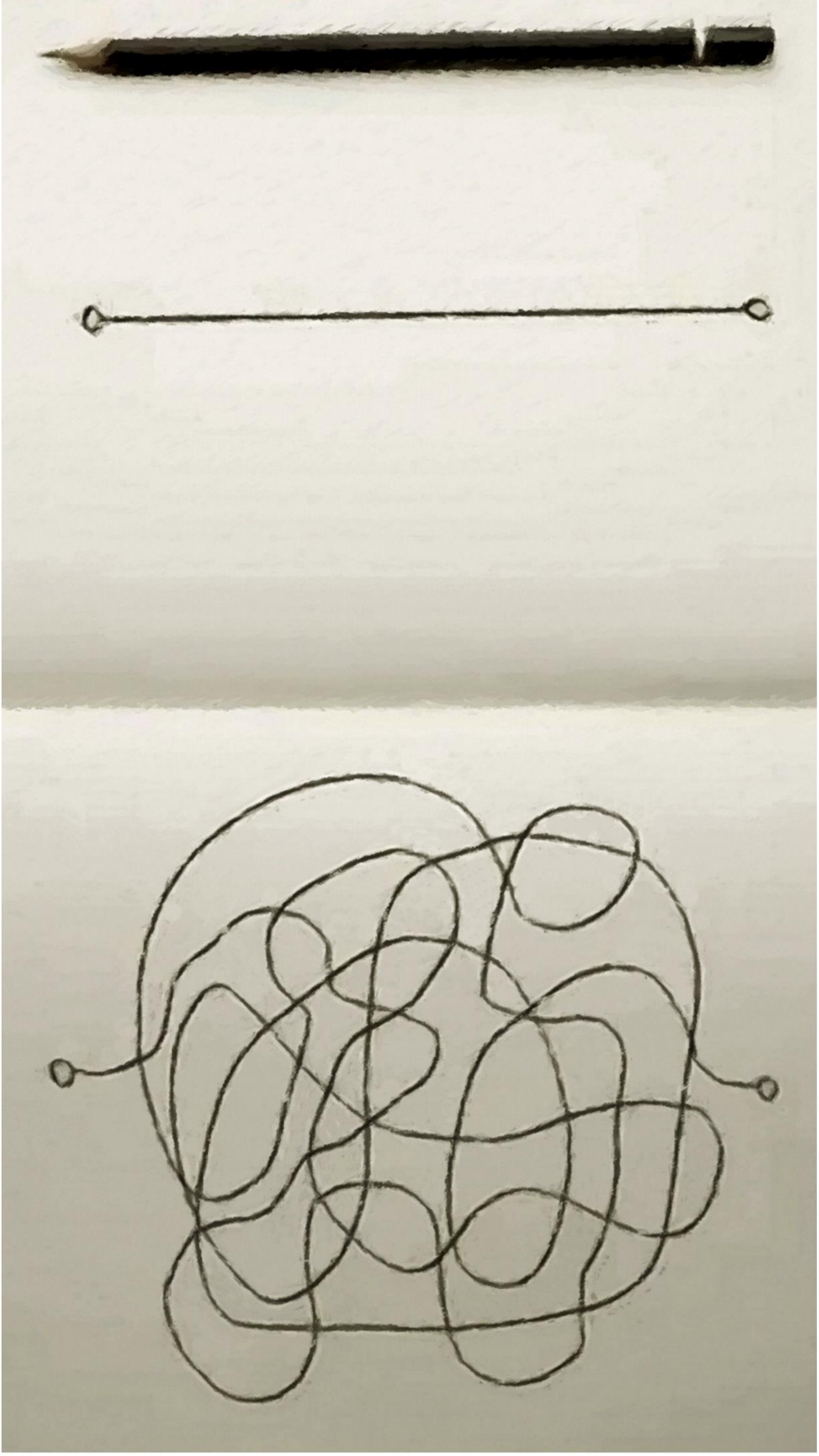
[24] European Commission, *Consultation document: Targeted consultation on options to enhance the suitability and appropriateness assessments*, available at: https://ec.europa.eu/info/consultations/finance-2022-suitability-appropriateness-assessments_en.
[25] Regulation (EU) 2019/1238 of the European Parliament and of the Council of 20 June 2019 on a pan-European Personal Pension Product (PEPP).

Therefore, we also raise the question as to whether the basic PEPP should not be considered – by default – a non-complex product?

The basic PEPP (initially called the *default investment option*) was meant to substitute the active choice of the pension saver and assign him/her to a standard investment option in the product. As such, the basic PEPP should be designed to be sufficiently safe, simple, and cost-efficient so as to accommodate the needs of a general investor profile. This approach is reflected in the definition of the basic PEPP (Art. 45(1) PEPP Regulation):

> *The Basic PEPP shall be a safe product representing the default investment option. It shall be designed by PEPP providers on the basis of a guarantee on the capital which shall be due at the start of the decumulation phase and during the decumulation phase, where applicable, or a risk-mitigation technique consistent with the objective to allow the PEPP saver to recoup the capital.*

In our view, the basic PEPP should be considered by default a non-complex product and could be sold under the execution-only regime to retail investors.



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