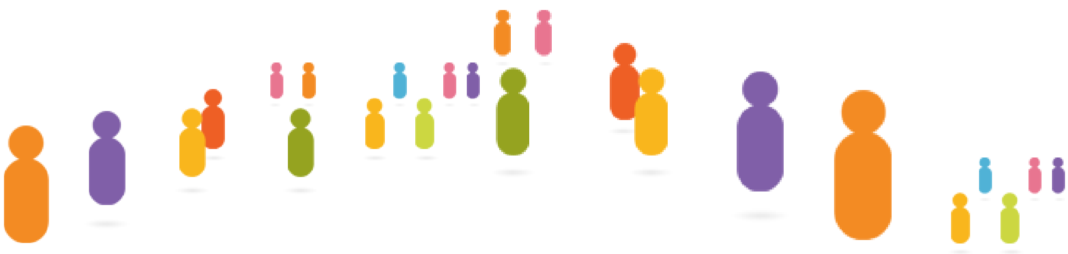
BEUC The European Consumer Organisation

The Consumer Voice in Europe

REVIEW OF THE MARKETS IN FINANCIAL INSTRUMENTS REGULATION / MIFID II

A consumer perspective



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Why it matters to consumers

Payment for order flow practices, where brokers receive payments from third parties for directing consumers' investment orders to certain trading venues, is a clear conflict of interest that prevent brokers from acting in the best interest of their client and should be banned in the EU. The European Commission should also ban the payment of inducements to financial advisers in the context of its upcoming EU Retail Investment Strategy.

1. Review of the Markets in Financial Instruments Regulation

On 25 November, the European Commission announced several reforms[1] to Markets in Financial Instruments Regulation (MiFIR) and MiFID II in the context of its Capital Markets Union Action Plan[2] published in 2020. BEUC welcomes the European Commission's proposal to ban 'payment for order flow' practices, which lead to conflicts of interests that can prevent brokers from acting in the best interest of their clients.

Unfortunately, the European Commission's legislative proposal to review MiFIR/MiFID II currently does not address other types of conflicts of interests that harm retail investors in the EU. Specifically, the payment of inducements to financial advisers can lead to biased financial advice that is not in the best interest of clients and should be banned in the EU (as already implemented in the UK and the Netherlands).

The European Commission is currently assessing how to ensure that consumers can take effective investment decisions with sufficient confidence, as part of its Retail Investment Strategy.[3] An external study mandated by the European Commission to assess the impact of inducement-related rules on the provision of investment advice is expected to be published by Q1 2022.[4] BEUC believes that inducements lead to biased financial advice that is often not in the best interest of clients, and have played a key role in many recent mis-selling scandals (see our campaign on **thepriceofbadadvice.eu**). We urge the European Commission and EU policymakers, as part of this upcoming Retail Investment Strategy, to introduce an EU-wide ban on the payment of inducements to financial advisers.[5]

[1] European Commission, 'Capital Markets Union: Commission adopts package to ensure better data access and revamped investment rules', https://ec.europa.eu/info/publications/211125-capital-markets-union-package_en

[2] European Commission, 'A capital Markets Union for people and businesses: New Action Plan', https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2020:590:FIN.

[3] BEUC, Consultation response to the EU Retail Investment Strategy, https://www.beuc.eu/publications/beuc-x-2021-073_public_consultation_on_a_retail_investment_strategy_for_europe.pdf.

[4] CEPS, Kantar, Milieu, 'Disclosure, Inducements and Suitability Rules for Retail Investors Study', https://www.ceps.eu/ceps-projects/disclosure-inducements-and-suitability-rules-for-retail-investors-study/.

[5] BEUC, 'The case for banning commissions in financial advice', https://www.beuc.eu/publications/beuc-x-2019-046_the_case_for_banning_commissions.pdf.

1.1. Ban on payment for order flow practices

According to our members (e.g. Test Achats, Stiftung Warentest), zero-commission trading models are becoming increasingly more popular in the European Union, allowing consumers to trade at increasingly low or no cost. However, consumers should be aware that there is no such thing as a 'free lunch', and that many of the zero-commission brokers offering services to retail clients often receive payments from third parties (i.e. 'payment for order flow') in order to execute their order. These costs are often ultimately passed on to consumers in the form of higher trading costs (e.g. see vzbv's warning to consumers about the 'hidden costs' associated with zero-commission brokers).

Payment for order flow models can incentivise brokers to route clients' orders to trading venues who are willing to pay higher inducements, to the potential disadvantage of the client. Specifically, payment for order flow practices incentivises brokers to route customer orders to the highest bidder, rather than to trading venues offering the best prices and fastest and/or lowest-cost execution for consumers. Since brokerage platforms benefit from payments from third parties that execute their trades, brokers may also have very little incentive to respect their 'best execution' obligations under MiFID II that require brokers to route client orders to execution venues that offer the best possible result for the client (in terms of price of the financial instrument, execution costs, speed of the transaction, etc.). Payment for order flow models decrease cost transparency for consumers, making it more difficult for consumers to easily compare the actual costs between brokers.

Payment for order flow practices are not vital in order to allow neo-brokers to continue to offer low- or no-commission trading opportunities to consumers (and we note that there are neo-brokers who offer zero-commission or low-commission trading to clients, without receiving payment for order flows in Europe[6]). Neo-brokers who offer trading services to clients generally have lower overhead costs compared to traditional brokers (such as banks), that should continue to allow them to offer competitive pricing to attract consumers to trade through their platforms. BEUC supports the European Commission's legislative proposal to ban payment for order flows under MiFIR/MiFID II.

BEUC members also have concerns about that smartphone trading and gamification techniques often employed by neo-brokers can systematically lead retail investors to take inferior investment decisions. There is evidence that smart-phone trading can promote very fast decision-making and a non-reflective environment for consumers that can facilitate bad decision making.[7] Behavioural prompts/nudges applied through gamification techniques could encourage harmful behaviours by retail investors, including for instance excessive trading by retail investors. The employment of gamification techniques may also desensitise consumers about the inherent risk associated with investing. For instance, prize offers offered to consumers when executing trades may encourage retail investors to focus primarily on the reward, rather than the risks associated with a trade, and potentially encourage investing behaviours that the retail investor may not normally have undertaken (including riskier investment strategies). The use of gamification techniques by neo-brokers should be investigated and addressed in the upcoming EU Retail Investment Strategy.

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[6] For instance, Bux Zero is a zero-commission trading platform that does not receive payment for order flows, yet allows consumers to trade stocks at zero or low cost. https://press.getbux.com/182124-zero-commission-investment-app-bux-zero-begins-its-european-rollout

[7] 'Smart(Phone) Investing?', https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3765652

1.2. Ban on the payment of inducements

Unfortunately, the European Commission's legislative proposal to review MiFIR currently does not address other types of conflicts of interests that harm retail investors in the EU. Consumers very often rely on financial advice when taking important financial decisions, such as taking out a life insurance policy or when seeking investment advice. When taking such decisions, consumers should be able to rely on impartial, competent and trustworthy advice, assisting them in carefully considering available investment options.

Today's commission-based financial advice model, where financial advisers are often remunerated by life insurers or fund managers for recommending certain products to clients puts leads to unmitigated conflicts of interest. The payment of inducements to advisers leads to biased financial advice[8] that is often not in the best interest of the client, and has played a role in many recent mis-selling scandals in financial services (see our campaign on thepriceofbadadvice.eu). Inducements encourage advisers to recommend products that give them the highest commissions, rather than advice that is in the best interest of the client.

For instance, in Spain, our member OCU recently warned consumers that the best-selling investment funds offered by the largest Spanish banks are often among the worst performing for consumers, while at the same time generating huge commissions for the banks. In Norway, our member Forbrukerrådet carried out a study showing how the commission-based financial advice model often pushes consumers into expensive investment funds that are not in their best interest. Studies[9] by EU authorities meanwhile show that high-cost investment funds, frequently promoted by financial advisers for the high commissions they attract, are often less likely to outperform their lower-cost alternatives.

In 2013, the United Kingdom and the Netherlands banned the payment of inducements for advice on retail investment products in the wake of several mis-selling scandals in their countries. Reviews carried out by the Dutch and UK authorities show that these reforms have had a profound impact in reducing conflicts of interests for adviser, and improving the financial advice that is given to consumers. The inducement bans in the UK and the Netherlands have also led to an increase in the distribution of simpler and lower-cost investment products to Dutch and British consumers.

For instance, a study[10] by the UK's Financial Conduct Authority found that the UK inducement ban reduced conflicts of interests and reduced product bias for financial advisers. The study found that following the UK inducement ban, product manufacturers who sold lower or no-commission products were "competing on a more equal basis" with manufacturers who used to pay very high commissions to financial advisers. For instance, tracker funds or passive investment funds (which used to pay out low or no commissions) attracted an inflow of investment following the UK inducement ban, as advisers began recommending products based on their merit, not for the commission they could attract. A study by the UK's FCA found that while as much as 60% of British fund savings were injected into the most expensive funds prior to their inducement ban, this proportion had fallen to 20% almost two and half years after the ban came into place:[11]

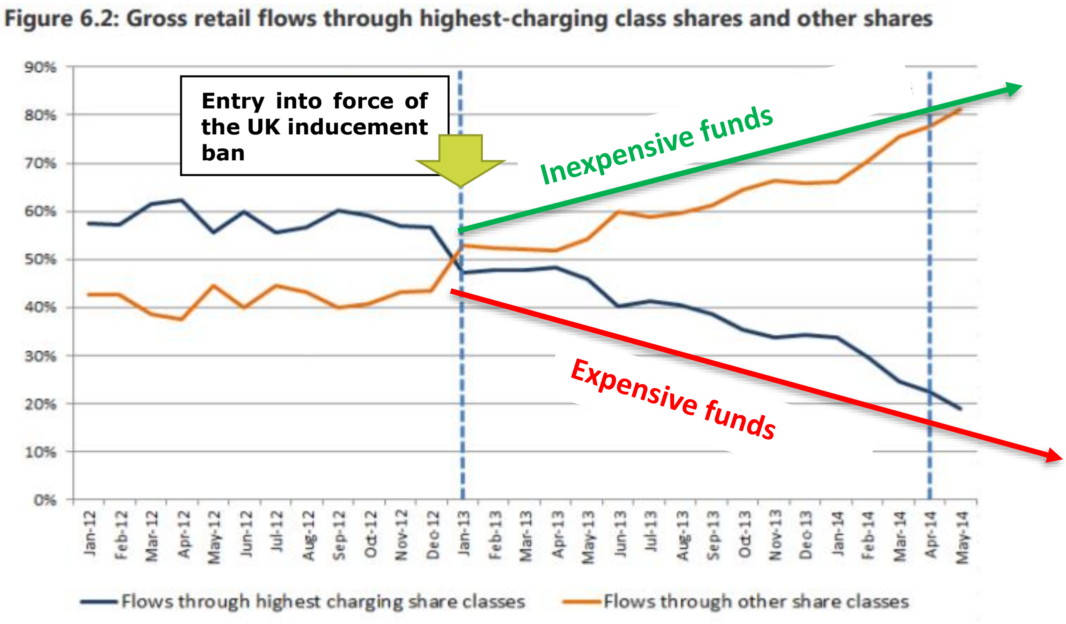
[8] BEUC, 'The price of bad advice: putting a stop to conflicts of interests in financial advice', https://www.beuc.eu/blog/the-price-of-bad-advice/

[9] ESMA, 'Performance and costs of retail investment products', https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1710_asr_performance_and_costs_of_eu_retail_investment_products.pdf

[10] Europe Economics, 'Retail Distribution Review: Post Implementation Review', https://www.fca.org.uk/publication/research/rdr-post-implementation-review-europe-economics.pdf

[11] Europe Economics, 'Retail Distribution Review: Post Implementation Review', https://www.fca.org.uk/publication/research/rdr-post-implementation-review-europe-economics.pdf, p. 74.

__Figure 1: Impact of the UK inducement ban on the types of investment products sold to UK consumers__



The payment of inducements to advisers leads to biased financial advice[12] that is often not in the best interest of the client. Inducements encourage advisers to recommend products that give them the highest commissions, rather than advice that is in the best interest of the client. We urge the European Commission and EU policymakers, as part of its Retail Investment Strategy, to introduce a Europe-wide ban on the payment of inducements to financial advisers. When it comes to making effective investment decisions, consumers need to be able to rely on impartial and trustworthy financial advice.

END

[12] BEUC, 'The price of bad advice: putting a stop to conflicts of interests in financial advice', https://www.beuc.eu/blog/the-price-of-bad-advice/

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