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10 July 2024

Financial Regulation Monthly Breakfast Seminar

Overview

- The EU Retail Investment Package
- The FCA's recent research on digital engagement practices used by trading apps
- The European Commission's consultation on AI in the financial sector
- The FCA's findings from its multi-firm review of outcomes monitoring under the Consumer Duty
- The ESAs' opinion on the SFDR

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The EU Retail Investment Package

Rob Moulton and Axel Schiemann

RIS in overview

- Original European Commission (EC) legislative proposal containing updates to MiFID II published in May 2023
- Focus on retail protection measures, but various proposals also impact professional client rules
- European Parliament (EP) and Council of the EU have now finalised their negotiating positions, setting out their proposed changes against the original EC text – gives some indication as to where the final text may land
- A significant moment in post-Brexit divergence – may be increasingly difficult to take a single approach to MiFID topics from this point onwards

Inducements

- EC proposed a new ban on the provision or receipt of inducements by firms providing execution-only/reception and transmission services to retail clients – EP and Council both disagree with this new ban, although the Council is suggesting new inducement criteria instead
- EC would retain pre-existing ban on inducements for firms providing portfolio management services, but EC proposals would change the wording to cover both the giving and receiving of inducements, whereas the current ban only requires firms not to "accept and retain" an inducement – EP and Council propose to maintain the current wording
- EC proposing to amend the existing exemption for minor non-monetary benefits by introducing an indicative threshold of EUR 100 per annum – EP and Council do not propose to reverse this
- **UK** – existing RDR/inducement ban is already wider, as it includes restricted advice
    - Overlap with payment for order flow controls

Best interests

- EC proposing to replace the existing “quality enhancement” test with three new criteria such that a firm would need to:
  - Provide advice on the basis of an assessment of an appropriate range of financial instruments;
  - Recommend the most cost-efficient financial instruments among the financial instruments identified as suitable; and
  - Recommend at least one product without additional features that are not necessary to the achievement of the client’s investment objectives and that give rise to extra costs
- EP proposes removing the third of these as well as making some improvements to the wording of the second criteria
- Council suggests moving the third criterion to suitability
- **UK** – no proposals at present to change the “quality enhancement” test

Product governance – value for money

- EC proposing that firms that are manufacturers and/or distributors of PRIIPs required to have clear pricing processes, and fees which can be justified and are proportionate
- Requirement to conduct an internal assessment, comparing the investment product with a relevant benchmark (developed and published by ESMA)
- Reporting to local regulators, and documentation of value assessments
- EP has suggested that benchmarks should be a supervisory tool only, use of peer group analysis, and that the value for money assessment should be internal
- Council has suggested firms could choose between using a benchmark or doing a peer group comparison, and that the value for money assessment should be internal
- **UK –** has similarities to the Consumer Duty Fair Value requirements

Costs and charges

- EC proposing some enhancements to the costs and charges provisions, including requiring firms to provide information to clients in a prescribed format and to provide retail clients with an annual statement on costs, charges, third-party payments, and performance
- EC proposals appear to go back on changes introduced by the MiFID "quick fix", by removing the automatic disapplication of costs and charges requirements in relation to professional clients and eligible counterparties – unclear if this is a drafting error
- Council has proposed rectifying this
- **UK** – provisions reflect the pre-existing EU MiFID requirements; the UK MiFID "quick fix" introduced exemptions for professional clients and eligible counterparties

Marketing communications

- Creation of an EU financial promotions style regime (applicable to marketing to and communications with professional and retail clients)
  - Marketing communications (similar to financial promotions) and marketing practices (very broad – any strategy to promote an investment)
  - Communications must be: fair, clear and not misleading; appropriate for the target audience; and disclose the essential characteristics and risks
- Firms required to produce annual reports for the management body on marketing communications and practices
- EP and Council agree with EC proposals
- **UK** – very similar to existing UK regime (except annual reporting)

Suitability and appropriateness

- EC proposed some additional requirements as part of the suitability assessment, including needing to obtain information about the composition of the client’s existing portfolio, ability to bear full or partial losses, investment needs, sustainability preferences and need for portfolio diversification (retail and professional clients)
- EP has suggested slight improvement to only require firms to obtain information about existing portfolios to the extent disclosed by the client upon request by the firm
- EC proposed tightened appropriateness assessment for retail clients, with new requirement to assess capacity to bear full or partial losses and risk tolerance
- EC also proposed requirement not to proceed after a negative appropriateness assessment unless the client expressly requests it (applicable to retail and professional clients)
- EP and Council agree with EC proposals on appropriateness
- **UK** – not replicated in UK

Client categorisation

- Updated criteria for opting up natural persons to elective professional status
  - Reduction of wealth criteria from €500k to €250k average over last three years
  - Third criterion (working in financial sector) expanded to include "undertaking capital markets activities requiring to buy and sell financial instruments or manage a portfolio which requires knowledge of the transactions or services envisaged"
  - New fourth criterion – proof of recognised education or training
- New criteria for legal persons – two of the following tests:
  - Balance sheet €100 million
  - Net turnover €20 million
  - Own funds €1 million
- EP and Council agree with EC proposals
- **UK** – No such changes proposed (recent FCA/HMT tussle)

Cross-border supervision

- EC proposed new reporting requirements for firms to home state regulator, highlighting countries, type of service, number of clients, number of complaints, marketing methods in other EU member states
- This would apply when providing services to all clients (not just retail)
- Regulators would then report this information to ESMA
- EP and Council agree with EC proposals

Next steps

- Trilogues set to begin relatively soon after summer break
- Unlikely EC will shift its attention away from the RIS or deprioritise it
- Commission and EP remain focused on making progress (key MEPs were re-elected)
- EC proposed that the changes would apply 18 months following publication of the final text in the Official Journal; EP agrees, but the Council is proposing to extend this to 36 months

The FCA’s recent research on digital engagement practices used by trading apps

Jonathan Ritson-Candler

Research note looking at problem behaviours

- On 20 June 2024, the FCA published a research note setting out findings on 4 digital engagement practices (DEPs) used by trading apps to understand their impact on consumer trading behaviour
- Born from implementation of the Consumer Duty and the FCA’s ongoing concerns around problem behaviours associated with trading apps
    - Focus on trading frequency and investment risk
- This research note was written by academics and members of the FCA
- The FCA makes clear that research notes are intended to bring together high-quality data insights to facilitate decision- and policy-making by the FCA
- However, research notes do not represent a definitive FCA position

What was the experiment?

- Looked primarily at phone-based trading apps that allow users to buy and sell investment products
- Examined the effect of DEPs and, in particular, aspects of gamification i.e., the use of game design elements in non-game contexts
  - Progressive rewards such as accumulating points or badges
  - Allowing users to benchmark their performance against others
  - Increasing the odds of winning prizes based on user engagement
- Referenced deceptive design and sludge but not focus of experiment
  - Deceptive design: interface elements that go against client’s best interest (e.g., high pre-set investment amounts)
  - Sludge: negative frictions that create unreasonable barriers for clients

  Both of which are contrary to Consumer Duty

Which DEPs were in focus?

1. **Flashing prices**: real-time price changes being indicated with red and green flickers and directional arrows
2. **Push notifications**: frequent pop-up messages about price movements
3. **Trader leaderboards**: a table of traders with the highest returns which participants could attempt to climb
4. **Points and prize draw**: a lottery to which participants received an increased chance of winning if they traded more

- These features attracted consumer attention, while conveying no additional information which could improve trading outcomes
- The experiment also built in access to pre-trade information about the investment product and assessed its use and impact of the DEPs

Key findings: impact of DEPs

- Each DEP was examined on a standalone basis, alongside a control, to primarily measure its impact on trading volume and investment risk
- Outcomes showed that **push notifications and points and prize draws** had the greatest impacts:
    - Significantly increased trading frequency (whereas **flashing prices** and **trader leaderboards did not**) – participants making ~1.6 more trades
    - And whilst they didn't lead to riskier investment portfolios at the end of trading, these DEPs did significantly increase the number of trades in riskier investments during trading
- None of the DEPs led to a less diversified portfolio

Key findings: impact of DEPs (continued)

- **Flashing prices** significantly reduced engagement with key investor pre-trade information
  - 10% decrease in clicks on information
  - Other DEPs had no effect
- An element of the experiment was to offer an alternative task to test the impact of DEPs on encouraging users back to the trading app
- Across all DEPs, users completed fewer of the alternative tasks and spent more time in the trading app, meaning all DEPs captured consumer attention
  - When coupled with flashing prices reducing engagement elsewhere, despite users spending more time in the trading app, they do not use that time to consult key investor information

Key findings: impact of DEPs (continued)

- DEPs have a larger effect on the trading frequency of potentially vulnerable participants
  - Those with lower financial literacy are induced to trade more by **flashing prices and trader leaderboards**
  - Notwithstanding the general lack of effect of DEPs on overall portfolio riskiness at the end of trading, the research found the most significant of this impact was on younger participants aged 18-34 – all of whom had a riskier portfolio as a result of every DEP compared to the control

Takeaways for firms

- For firms that utilise these or analogous practices, the research acts as a helpful reference point against which to review these practices
- Particularly if you are in-scope of the Consumer Duty as these practices may not be leading to overall good outcomes for clients and may conflict with requirement not to design features which exploit the behavioural biases of consumers

The European Commission’s consultation on AI in the financial sector

Becky Critchley

European Commission targeted consultation on AI in the financial sector

- EU AI Act expected to be published in the OJ on 12 July 2024
- On 18 June 2024, the European Commission published a targeted consultation on AI in the financial sector
- EU / UK divergence
- Impact on firms' global AI frameworks

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The FCA's findings from its multi-firm review of outcomes monitoring under the Consumer Duty

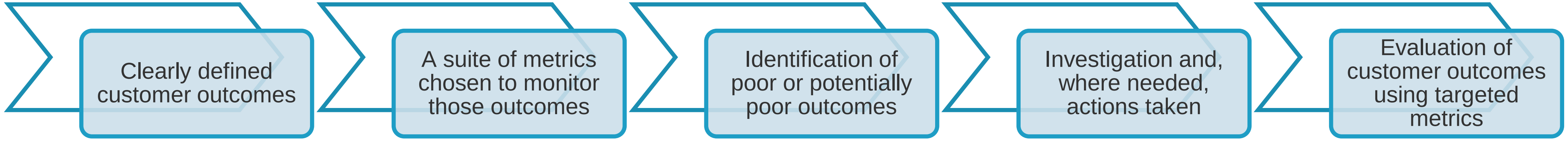
Becky Critchley

Insurance multi-firm review of outcomes monitoring under the Consumer Duty

- What?
  - FCA review of outcomes monitoring of 20 larger insurance firms under the Consumer Duty
  - Consumer Duty requires that "*firms must regularly assess, test, understand and evidence the outcomes their customers are receiving*"
- How?
  - FCA requested board and / or committee reporting
  - FCA asked firms to show how they monitor, assess, and test the outcomes customers are receiving, along with actions firms had taken after identifying poor outcomes
  - FCA assessed responses against PRIN 2A.9

Insurance multi-firm review of outcomes monitoring under the Consumer Duty (continued)

- FCA conclusions
  - Effective causal chain:



  - Examples of good and bad practice
    - The design of monitoring approaches
    - Types of data
    - Interpretation and scrutiny
    - Monitoring different groups of customers
    - Actions taken by firms to address poor outcomes
  - Assessment against the four customer outcomes
- Next steps

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The ESAs' opinion on the SFDR

Jaime Martin

ESAs Propose New SFDR Classification System

- On 18 June 2024, the European Supervisory Authorities (ESAs) published a joint opinion on the Sustainable Finance Disclosure Regulation (SFDR)
- The ESAs suggest that the European Commission should replace the current SFDR disclosure framework with either **voluntary product categories**, **sustainability indicators**, or a combination of both. They also urge the Commission to carry out robust consumer testing when developing any potential policy options
- The opinion was delivered at the own initiative of the ESAs (meaning it was not requested by the Commission). Reviews of the SFDR and related Regulatory Technical Standards are ongoing, although their timing and status is currently uncertain and will be determined by the new European Commission

Product Classification

- The ESAs suggest replacing the current Article 8 and Article 9 disclosure regimes with product categories. The ESAs suggest two categories that could be used as a starting point: “sustainability” and “transition”. These categories would be voluntary, although the ESAs propose that the Commission could test a mandatory regime

Sustainable Products	Transition Products
• Products that invest in economic activities or assets which are already environmentally and/or socially sustainable • Minimum threshold for environmentally sustainable products based on investments in taxonomy-aligned economic activities, but no potential percentage threshold • The portion of the investment that does not count towards the minimum threshold should at least comply with the “do no significant harm” principle and good governance requirements, provided that these concepts are more clearly defined	• Products that invest in economic activities or assets that are not yet sustainable, but which improve their sustainability over time to become environmentally or socially sustainable • Commission should consider carefully what proportion of a product’s investments should initially comply with the requirements • Appropriate transparency obligations but no requirement to apply the “do no significant harm” principle • Consider whether it would be desirable to include an “investor’s impact” sub-category

Disclosure and Marketing

Type of Financial Product	Disclosure and Marketing Requirements
Category products	• Disclosures in regulatory documentation appropriate to the category • Naming and marketing consistent with category
Products that have some sustainability features but do not qualify for categories	• Limited disclosures in regulatory documentation on sustainability features • Restrictions on naming and marketing
Products with no sustainability features	• Minimal disclosures on adverse impact on sustainability • Disclaimer to make clear that product has no sustainability features • Restrictions on naming and marketing

- In contrast, the UK SDR only imposes disclosure requirements and naming and marketing requirements for products which either qualify for a label, or which do not qualify for a label but have sustainability characteristics. The UK regime does not impose requirements on products with no sustainability features, although all firms must comply with the FCA's anti-greenwashing rule

Sustainability Indicators

ESAs Opinion on SFDR

eba European Banking Authority · eiopa · ESMA

Sustainability categories for financial products

"Sustainable" category
- Focus on sustainable investments
- Clear and objective minimum criteria
- EU Taxonomy basis for environmental sustainability

"Transition" category
- Focus on transition investments
- Mix of KPIs
- Consider initial ambitious but realistic share of investments that can grow over time

Non-categorised products
- Products that do not fulfil the conditions to fall under the proposed categories

Sustainability indicator(s) for financial products

Option 1: one indicator for products within and outside the sustainable and transition categories

Option 2: one indicator per sustainability category (non-categorised products not included)

Examples for grading

A B C D E

Sustainable category A B C D E

Transition category A B C D E

Summary of the ESAs' recommendations to the Commission

a) The commission could consider the introduction of a product classification system, based on regulatory categories and/or sustainability indicator(s) to help consumers navigate the broad selection of sustainable products and support the full transition to sustainable finance;

b) The categories should be simple with clear objective criteria or thresholds, to identify which category the product falls into. The ESAs encourage, at least, categories of 'sustainability' and 'transition';

c) A sustainability indicator could refer to environmental sustainability, social sustainability or both, illustrating to investors the sustainability features of a product in a scale;

d) Options for product categorisation and/or sustainability indicator(s) should be consumer tested and consulted on. With clear product categories and/or sustainability indicator(s), sustainability disclosures would not need to be as detailed and extensive;

e) The Commission could revisit the coexistence of the two parallel concepts of "sustainable investment" as defined in the SFDR and Taxonomy-aligned investment as defined in the EU Taxonomy. The EU Taxonomy constitutes a science-based reference point against which to measure environmental sustainability, whereas the SFDR is more principle based and less prescriptive that the EU Taxonomy when it comes to measurement of sustainable investments. The Commission should prioritise completing the EU Taxonomy and extend it to social sustainability;

Summary of the ESAs’ recommendations to the Commission – continued

f) The ESAs strongly recommend that the Commission ensures that sustainability disclosures cater to different investor needs, and improvements in sustainability disclosures should take into account different distribution channels, including digital ones, and ensure consistency of information provided. The Commission should prioritise only essential information for retail investors while professional investors may benefit from more detailed information;

g) The Commission could carefully reflect on whether to include other products in the SFDR scope to ensure harmonised disclosures for both products currently in the scope of SFDR and any other products that could be brought in to the scope;

h) Information on key adverse impact indicators could be considered for all financial products, based on a cost-benefit analysis justifying the introduction of such requirement; and

i) The Commission could evaluate the introduction of a framework to assess the sustainability features of government bonds, taking into account the specificities of that asset class.

Recent Thought Leadership

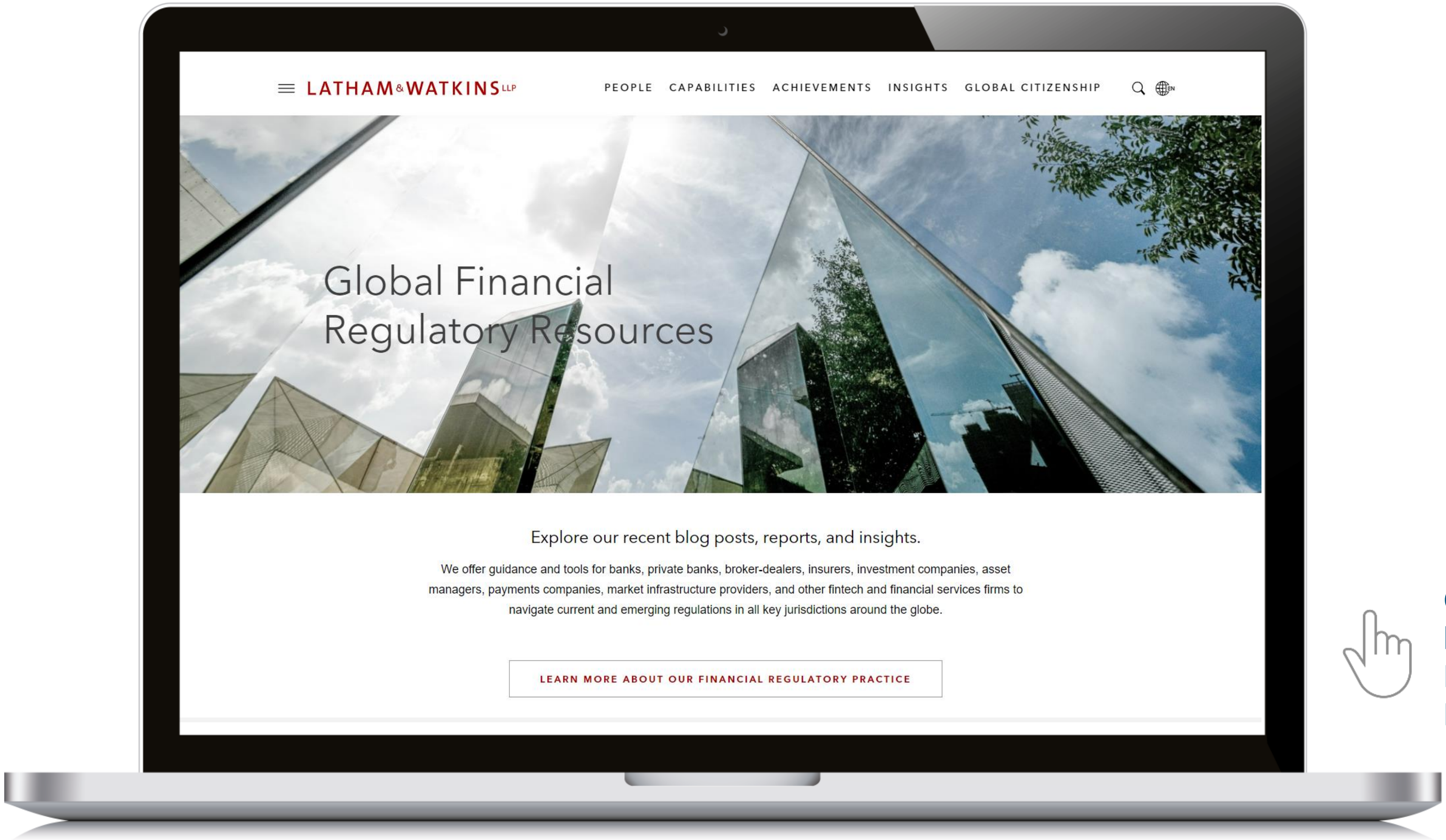
Monthly London Webcast Materials

Each month the UK and European Financial Regulatory lawyers at Latham & Watkins host a presentation and discussion covering recent changes to financial services regulation.

VIEW

- EU AI Act: Navigating a Brave New World
- Consumer Duty – The Final Countdown?
- ESAs Propose New SFDR Classification System
- ESMA Sets Out Good Practices for Calls With Analysts Ahead of MAR Closed Periods

Our Global Financial Regulatory Resources Page



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