Frankfurt am Main,
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BVI's comments regarding ESMA's technical advice to the Commission on investor protection issues of MiFID II

BVI[1] would like to present its views on the following investor protection issues which are of particular importance in light of ESMA's technical advice:

1. Legitimacy of inducements in the context of non-independent advice:

According to ESMA, inducements are not designed to enhance the quality of a service if (i) they are not justified by the provision of an additional or higher level service to the relevant client, (ii) they are without tangible benefit to the relevant client and (iii) in relation to on-going inducements, are not justified by the provision of an on-going benefit to the relevant client.

We appreciate that ESMA has removed the prohibition to receive inducements if they are used to pay or provide for goods or services that are essential for the recipient firm in its ordinary course of business. Nonetheless the negative list of circumstances not meeting the quality enhancement test is non-exhaustive and it is not entirely clear whether the positive criteria included therein create safe harbour rules. Even if they will be considered as safe harbour rules, the use of inducements to finance other business activities available for clients might still be prohibited on the basis of ESMA's advice. This could result in a de facto ban on established distribution models based on commissions even though the legislative foundation in Level 1 remains unchanged. This result would run counter to elementary decisions of the EU legislator. In order to prevent such unintended outcome, the legal certainty of the final Level 2 rules should be enhanced. In particular, it should be clarified that reception or provision of commissions shall be generally designed to enhance the quality of the relevant service in case the MiFID firm conducts its business in a way which meets at least one of the positive criteria listed in para. 11 i), a) to c) of ESMA's advice (p. 141 *et seq.*). In addition, commission payments should be generally treated as designed to enhance the quality of the relevant service if they are used to finance infrastructure which ensures clients' access to advice or other distribution services which could no longer be offered otherwise.

According to ESMA's advice, MiFID firms are not explicitly allowed to use inducements to finance goods or services essential for their ordinary course of business. Accordingly, ESMA and national regulators may still consider that inducements should not be used to finance the core business except for the part that provides for the additional or higher level service. There are situations where a service would not be provided at all to clients without a commission payment. It might simply be too expensive for an investment firm to provide investment services if commission payments are prohibited, e.g. in less populated regions. It is necessary to clarify that for financing of such services inducements may be used. As a general remark, it would be helpful to reduce complexity of the wording, e.g. the double negative of the enhancement criteria is difficult to comprehend.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 84 members manage assets in excess of EUR 2.4 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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2. Treatment of research services in relation to portfolio management

According to ESMA's proposal, it is only acceptable for an investment manager to receive research if the asset manager pays for research either (i) out of its own resources (e.g. after accordingly increasing the management fee) or (ii) from a separate research account which is funded by a specific charge based on a fixed budget not linked to the volume and/or value of transactions and allocated as fairly as practicable to the various clients' portfolios. Execution brokers have to price all services and goods rendered; services and goods other than the provision of research may not be influenced by levels of payment of execution services.

ESMA's proposal regarding the use of dealing commissions does not address any of the concerns regarding potential unintended consequences asset managers, issuers and brokers have raised in the consultation process. Rather, it will still significantly change the market although no solutions were discussed at Level 1. In addition, it is not clear how the proposal may be implemented. In our view, benefits and detriments of any regulatory approach should be subject to a thorough analysis. In this respect, we support a regulatory approach which will address ESMA's concerns including full disclosure of payments to brokers and research received as well as related costs. Nevertheless, we appreciate ESMA's clarification that asset managers may charge clients for research separately.

The effect ESMA's proposal will have on the market of research is completely unclear. It is likely that the amount of research will decrease which will possibly result in reduced research coverage and impair pricing of financial instruments. This would in particular affect the small- and medium-sized companies, thereby contradicting the European legislator's intention to improve the access for such companies to the capital market. In addition, ESMA's proposal could be understood as prohibiting face-to-face meetings between asset manager and companies if facilitated by a third party such as a broker. Since brokers usually set up several meetings for both sides, without their involvement administrative complexity would increase. A likely consequence would be a significant reduction of face-to-face meetings which again would contradict the European legislator's intention to increase shareholder engagement. In any case, the ESMA proposal is unclear with respect to several points e.g. regarding the question how an asset manager could comply with ESMA's proposal if some of his clients do not agree to a specific research charge or if in particular non-EU brokers still deliver research without specific prices.

3. Classification of Alternative Investment Funds (AIFs) as complex instruments

ESMA states that all investments in non-UCITS collective investment undertakings should be considered complex, regardless of whether they take the legal form of units or shares. As a consequence, all non-UCITS would per se qualify as complex products without any possibility to run a complexity test.

ESMA's general statement that all AIFs should be considered complex without any access to a complexity test would lead to an inappropriate treatment of AIFs and is not backed by the Level 1 text. Many AIFs are structured and regulated as retail funds and hence understood as products for retail investors and licensed as such by the competent authorities. In addition, future developments in legislation might impose stricter or other rules for complex instruments as currently envisaged by MiFID II. A qualification of highly regulated retail AIFs as complex products without any access to the complexity test should therefore be seriously called into question.

AIFs are often wrongly considered as risky products due to the original aim of AIFMD to regulate hedge funds and private equity funds. In reality, AIFs are all non-UCITS collective investment undertakings and therefore cover a broad range of products including highly regulated retail funds hardly differing from UCITS. A broad presumption that all AIFs are *per se* complex products means that according MiFID II all shares or units in AIFs may no longer be sold by way of execution only. In addition, future regulation may bring further rules for complex products, which might not be appropriate for all highly regulated retail AIFs.

ESMA's implicit **interpretation** that AIFs are instruments which are excluded from the list of non-complex instruments in Art. 25 para. 4 (a) (i) **is not correct**. Besides a reference to the MiFID II Level 1 text which leaves room for interpretation, ESMA falls short of any reasoning. The exclusion in MiFID II Level 1 just prohibits that *shares* in AIFs are automatically being considered as non-complex just because they are listed. The legislator´s intention was to avoid that a management company would list shares in AIF with the only purpose of qualifying them as non-complex products. Had the legislator intended to exclude all *shares and units* in AIFs from the complexity test, he would have added such exclusion either explicitly in subparagraph (i) or drafted a general exemption for shares or units in investment funds with the exclusion of shares or units in structured UCITS and all non-UCITS investment funds.

4. Product information, especially transparency of product costs and charges

According to ESMA's final advice, product costs to be disclosed at the point of sale shall generally comprise transaction costs and contingent costs such as performance fees. Disclosure shall occur on an ex-ante *basis and encompass both monetary and percentage figures. The currently valid transparency standards of the UCITS KIID are not considered appropriate by ESMA. In addition, clients shall be informed about the functioning and performance of financial instruments in different market conditions.*

Standards of product cost disclosure are stipulated by other EU frameworks such as the PRIIPs Regulation and the UCITS Directive. It is of paramount importance that these standards prevail also under MiFID II and that distributors remain allowed to rely on product costs as set out in the UCITS KIID or the future PRIIPs KID for the purpose of disclosure at the point of sale. Hence, these two EU frameworks should be considered *leges speciales* in terms of product information. This relates also to the question whether presentation of performance scenarios should be required.

The EU financial market framework provides for rules on product information to be made available by product manufacturers. Such rules are already in place for UCITS which make available a Key Investor Information Document since 2011 and are under discussion for other financial instruments qualifying as PRIIPs. For distributors confronted with a wide variety and different structures of financial instruments in the EU market, it is essential that MiFID II acknowledges such information provided in line with the applicable EU provisions as appropriate and sufficient for fulfilling their own information duties. It must be also noted that, unlike the UCITS or PRIIPs framework, MiFID II does not provide for a limitation of liability in terms of product information. Thus, should distributors be obliged to and liable for disclosing product details which are not included in the relevant KID/KIID, it must be feared that many of them will either retreat from the "open architecture" and focus on products from affiliated companies or shift their business models to products not covered by the MiFID regime such as building loans or insurance contracts. Either outcome clearly would not be in the interest of European investors.

In addition, it should be recognised that UCITS and other retail funds featuring a KIID according to UCITS standards have been granted a temporary exemption under the PRIIPs Regulation and are allowed (and required) to provide a KIID according to UCITS standards at least until December 2019. The UCITS KIID does not provide for numerical disclosure of transaction costs and includes presentation of past performance instead of performance scenarios. These specificities of UCITS product information should be acknowledged as appropriate and sufficient under MiFID II as long as the temporary exemption is in place. Any other approach would effectively undermine the temporary exemption enshrined in the PRIIPs Regulation and thus violate the uniformity of the EU legal system.