INVESTMENT PRODUCT FRAMEWORKS AND INVESTOR NEEDS

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Meeting investment needs: the building blocks of the CMU

2023 is a significant year. For Ireland, it marks fifty years of EU membership and the first home rugby Grand Slam win in 75 years. Across the EU, it is the thirtieth anniversary of the single market. In that time, huge achievements have been made, not least through the development of a vibrant fund and asset management industry. We now have an opportunity to build on these achievements to deepen and develop our Capital Markets Union.

Enabling financing and directing it to where it is needed

We are committed to building on the competitive and sound regulatory environment that has been developed for the fund and asset management industry. This is because investment products play a crucial role for retail and institutional investors and economic growth. And that is what the CMU is about: deepening our markets, enhancing our financial stability and providing greater support and appropriate capital levels to our companies. The last few years and even weeks have reinforced the significance of these aims.

The AIFM and UCITS Directives have delivered successful brands that are recognised globally, illustrating the importance of EU frameworks in achieving CMU objectives. Through the ongoing review of AIFMD and the consequential updates to the rules applicable to UCITS, we will continue to enable the success of UCITS and AIFs and reflect market developments through targeted amendments.

For example, we support the introduction of an EU framework for loan originating AIFs. Ireland was one of the first EU member states to introduce a domestic regulatory framework for loan origination, recognising the importance of the activity for raising financing. While regulation should support and enable activities, it must also address the associated risks. The Council's General Approach on AIFMD includes safeguards to manage the risks associated with loan origination, striking an appropriate balance. It is important that these safeguards are retained in the final agreement, in addition to the General Approach's clarifications on the rules for delegation which provide for increased transparency and supervisory cooperation without undermining the global funds model or the goals of the CMU.

Investment products play a crucial role for retail and institutional investors and economic growth.

Work continues at pace on the AIFM and UCITS Directives. Meanwhile, the revised ELTIF Regulation was adopted earlier this year, signalling a further step change and contribution to the CMU. Given the changes to the Regulation were designed to make the ELTIF product more attractive to asset managers and investors alike, we are confident that the ELTIF product will be a significant player in directing investment to areas of the economy where it is needed.

Going further, more quickly

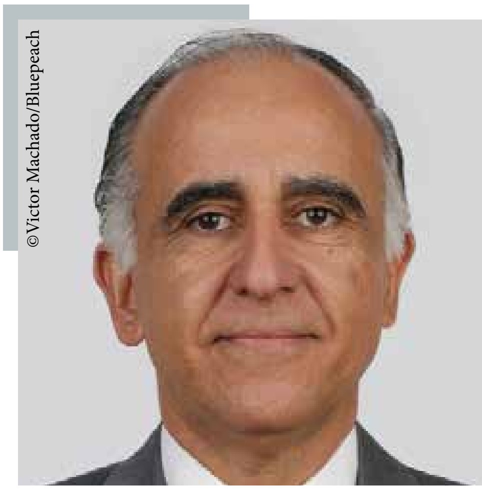
Our ambition and commitment goes far beyond current achievements. We fully support the recent op-ed co-signed by the Presidents of the European Council, European Commission, Eurogroup, ECB and EIB which emphasised the urgency and collective effort needed to deepen the CMU, not least to drive forward the green and digital transition.

Looking ahead, we support the plans for the upcoming Retail Investment Strategy to ensure that investors can access a range of cost efficient and suitable financial services and products. The strategy aims to grow the EU's investor culture and maintain strong retail protections. It is critical that the strategy incorporates tangible actions. The focus on financial literacy within the CMU seems particularly pertinent to the Retail Investment Strategy: we must ensure that retail investors, as they become more confident and autonomous, possess the knowledge and skills necessary to assess investment options available to them.

The strategy is a good opportunity to address concerns and ensure the market works as well as it can for retail investors, boosting the EU's competitiveness while addressing related risks. Furthermore, the strategy may prove opportune to address cross-cutting issues, including the costs arising from regulation. We look forward to actively contributing to discussions.

Digital innovation will be key in ensuring accessibility to investment products that are easily understood and that deliver for investors and Europe's economy. The EU has shown itself to be a leader in the digital and sustainability fields. The EU and, crucially, financial services providers, must draw on this experience. We must challenge ourselves to ensure regulation enables innovation rather than stifling it, identifying and assessing the risks while striking an appropriate balance in addressing such risks.

Eurofi plays an important role in the policy making process by bringing together financial services providers, regulators, policy makers and legislators to generate discussion and foster ideas. I look forward to taking part in Stockholm.



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Value for money in the capital markets

The European Commission's Retail Investment Strategy and the Capital Markets Union seek to improve market outcomes and empower retail investors to invest according to their preferences and risk appetite, so they can take full advantage of the capital markets.

These objectives underline the relevance of the value for money concept applied to capital markets. Ensuring "Value for Money" means ensuring that financial activity fulfils its main purpose of channelling savings into value-generating investments.

We, in the CMVM, consider that a financial product offers value for money to the investor when the costs and charges are due and appropriate in relation to the expenses incurred by producers (and distributors) and to the expected benefits for the target market, considering its needs, characteristics and objectives.

Thus, a product with a certain level of cost/benefit or risk may offer value to an investor with a certain profile, but not to another.

But, are our investment product frameworks giving retail investors the tools they need to find value in financial markets?

No undue costs

A key rule is the prohibition on charging undue costs, which applies to both UCITS and AIFs.

Costs are, in fact, a key item in the assessment of value since, on the one hand, the return the investor gets is indissociable from the costs, and on the other hand, costs are mostly under the control of producers and distributors and they are pre-established, unlike market-dependent returns.

Despite the simplicity of this principle based approach, its interpretation and application is difficult because it is a rule without any clear pathway on how it might be implemented. This fact clearly demonstrates the value of the supervisory briefing on the supervision of costs in UCITS and AIFs, issued by ESMA in 2020.

Not surprisingly, in ESMA's Common Supervisory Action of 2021 on the costs & fees of UCITS, divergences were found between market participants on the very concept of what constitutes undue costs.

This is one example where further specification is necessary to ensure fair competition in the EU market, minimizing the risk of arbitrage, and a better result for investors.

Are retail investors getting the tools they need to find value in the capital markets?

Information quality

Clear, concise and comparable information on costs and expected returns is another important tool if we aim to maximize the value investors derive from financial markets.

In this regard, the PRIIPS legislation has established the provision of a pre-contractual key information document (KID) for several products. It is even applicable to UCITS funds, which for many decades have had their own pre-contractual information document. This is a relevant step towards harmonisation, despite the adaptation effort required by the industry.

The creation of standardised documents common to all EU countries is a regulatory advance at EU level and the KID allows, in fact, to transmit to the retail investor the most relevant information in a clear but summarized manner. The harmonised risk indicator is a very useful tool, allowing comparison between products. The return scenarios are also an essential element of information, which has been recently perfected so that its application to different products is the most appropriate.

The CMVM carried out a 'value for money' supervision exercise focused on the PRIIPs market in which, based on the information made available in the KID, it identified products with low expected benefits for the target market (return estimates of scenarios and relatively low guarantees) and relatively high costs.

Easily accessible information

The information summarised in the KID is important, but extracting the information in a manageable format is a resource-consuming task.

NLP (Natural Language Processing) tools could be used to extract information from KIDs, and tests in this field are already underway, including by ESMA itself.

But an even simpler solution would be to make it mandatory for the KID and other standardised documents to be published in a machine-readable format. This would contribute to the efficiency of the market in general, by making the comparability of financial products easier, and facilitate supervision by NCA.

Embracing innovation and technology in information disclosure could increase the simplicity and accessibility of information to a level that allows the retail investor to make better decisions, while also facilitating the work of those who inform and advise those investors.

A holistic approach that seeks to improve formats and content, and which allows products to be compared in terms of their value, regardless of each investor's perspective, has to be the way forward.

All these improvements can produce a significant and positive impact on increasing "Market Based Finance" across Europe. This is something that, although not often mentioned, is the enabler of a union of capital markets and ultimately of the Capital Markets Union.

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Deep seated market trust is achieved when clients' interests are truly at heart

The CMU aims to create a single market and get money from investments and savings flowing across the EU. This is ambitious and important for the EU capital markets. Flourishing capital markets will benefit companies, investors and consumers.

Creating a culture of investing is not an easy task and legislation is a key instrument to enhance participation in capital markets, particularly from retail. In legislative proposals, it is important to strike the right balance between making capital markets more attractive (less regulatory complexity and administrative burdens), while at the same time safeguarding the interests of investors. The proposed measures regarding clearing services, insolvency rules and the Listing Act are welcome steps in the right direction. This article discusses proposed amendments to various legislative frameworks, proposes to consider an advise-light regime and emphasizes that clients' interest should be the core in financial services.

Legislative frameworks

The existing EU frameworks for financial instruments such as UCITS, PEPP and AIFMD contribute to standardization. Within these frameworks products can be designed that serve consumers' needs and interests. As a regulator we appreciate the prospect of further clarification and harmonization of delegation structures and liquidity management tools in the AIFMD and UCITS. Further clarification on delegation and substance is very welcome to reach the desired level playing field within the EU. Funds should have sufficient instruments to manage and mitigate liquidity risks. Having adequate and sufficient LMTs is key in addressing micro- and macroprudential risks.

Standardized portfolio investments might be a way to lower barriers for certain investors. Depending on clients' risk appetite, investment horizon and goals, a portfolio with a standardized asset allocation is an option. In NL, the guided execution-only is offered as an alternative to investors. Under strict conditions, simplified portfolio management could be achieved with a less extensive suitability test.

Firms should focus on low costs and ongoing expectation management in their product offering.

Costs

It is questionable whether regulatory changes are needed to facilitate the industry's creativity to make their propositions attractive for clients. A light-advice regime applicable to such products would be a cost-effective alternative to full-on advice (with all the costs and quality requirements).

Yes, we are focusing on the costs again. Basic mathematics demonstrate slight percentual differences in costs have a significant impact in the long run. A fee of 0.50%, median fee for equity funds according to Morningstar in NL[1], at first glance does not differ that much from for example 1.70%, not an uncommon percentage in the EU. It may not look like a big difference for the average investor. However, on the long-term investing horizon it has a significant impact. If you invest 1.000 euro in an equity fund with 0,5% costs and a yearly return of 5%, the nominal value of your fund after 30 years in NL would be: 3.750 euro. With 1.70% the value would be: 2.630 euro. That is a difference of more than 40%.

Clients' interest at heart

In addition to clear legislation, it is important that also the financial services industry puts the clients' interest first. Only when clients' interest is at the heart of business decisions can the needed investor's trust in financial services be preserved or (re-)gained. We cannot expect all investors to understand everything in the financial sector; information asymmetry in the financial sector will always be high. Therefore, it is key that especially consumers are able to rely on financial products that are well designed, that distribution channels function appropriately[2] and that correct and useful information is provided.

It is particularly important to carefully consider the design of a product. Clients' interest is key in the product development phase. A product should always live up to its expectations. For this reason, the intention to enable open end ELTIFs is viewed with some scepsis. Having exposure to infrastructural products enables diversification and may contribute to optimizing portfolio return, particularly for a long run investment for retirement. Yet, the characteristics of the underlying investments (e.g. bridges, tunnels) make it not that easy to liquidate these assets when investors of an open end fund want to sell their participation. Therefore, managing expectations on illiquid assets is key!

To conclude: one must be very careful, particularly when it comes to expanding the product offering to retail clients. Foreseeable issues are at hand and as we all know trust is hard to gain but easy to lose.

[1] https://newsroom.morningstar.com/newsroom/news-archive/press-release-details/2022/Morningstar-Publishes-Global-Study-of-Fees-and-Expenses-in-the-Fund-Industry-Finds-Fees-Continue-to-Fall-Yet-Room-for-Improvement-in-Industry-Structure-Remains/default.aspx

[2] In NL a ban on inducements was introduced in 2013 for financial advisors.

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Policy must support the EU ETF sector by considering the impact of regulation

Exchange-traded funds (ETFs) are one of the most successful new product structures introduced in recent memory with global AUM exceeding $9.6tn, of which more than $1.5tn is in European-domiciled products[1].

ETFs are often held up as an example of the "democratisation of investment" due to their transparency, low cost, and single share class structure, in which all investors, big and small, receive the same pricing. The secondary market further enhances ETFs' appeal by providing both potential cost savings and incremental liquidity to investors.

But while ETFs have attracted significant investor assets, there remains one area in which ETFs, and their unique characteristics, are consistently overlooked – the drafting of financial market regulation.

European fund industry regulation continues to be drafted from the narrow perspective of actively-managed funds. When applied to passive ETFs, this can lead to incorrect assumptions about everything from how fund holdings are determined and how they can change, to the information available to the portfolio manager about underlying companies.

Indeed, the challenge of properly applying to ETFs a body of regulation that has been drafted from an active investor perspective has been exacerbated by the rapid implementation of ESG-related regulation in recent years, such as the EU SFDR. In general, these rules presuppose a degree of flexibility that is not only impractical in the context of passive ETF portfolios holding thousands of securities, but in many cases has been explicitly removed from the ETF manager.

As a simple illustration, consider a fund's name. With the growth of ESG investing, regulators have a legitimate interest in ensuring that terms such as "ESG", "sustainable", "green" etc. are not misused, hence recent regulatory initiatives governing the naming of such funds.

It is important to note here that the names of most ETFs are a formulaic combination of the name of the asset manager and the name of the benchmark the manager seeks to replicate. However, current discussions around the use of ESG-related language ignores this connection between passive funds and their benchmarks (whose names are not in scope) and only considers the fund holdings and fund name.

Taking the perspective of an active manager, the implication is that, if the fund failed to meet the requirements

Regulators must support access to one of the most significant democratising investment trends.

for the use of "ESG" in the name, then the portfolio manager can either change the fund holdings or change the fund name.

But neither option is available in the case of passive ETFs where the portfolio manager has little discretion to deviate from the target holdings. And to replace or remove the "ESG" in the name would mislead investors by suggesting the ETF is tracking a different benchmark. A lack of coordination between fund regulations (e.g., the EU SFDR) and benchmarks regulations (e.g., the EU BMR) has the potential to create serious challenges for ETFs and passive strategies.

Indeed, the consideration of ETF specificities is also largely absent in other parts of financial regulation. The impact on ETF primary market operations of the since-delayed-and-reviewed mandatory buy-in regime under the EU CSDR was not considered by policymakers ex-ante despite its well-known flaws.

Lessons must therefore be learned by policymakers in order to avoid similar policy failures in the trading and settlement space. This is particularly pertinent given the live discussions in Europe on the transition towards a T+1 settlement framework where ETF specificities must be taken into account in the policy development phase, particularly for EU ETFs investing in non-EU assets.

Additionally, in the context of the ongoing review of the EU MiFIR, only after significant industry engagement have policymakers begun to see the potential utility – for retail investors, global institutional investors, and regulators themselves – of a pre- and post-trade consolidated tape covering ETFs.

Not only would such a tape allow investors to make better informed investment decisions and support best execution, but it would allow the EU ETF sector to genuinely compete with other large jurisdictions, such as the U.S., by showcasing the true liquidity available in competing EU-listed products. It would also give regulators a more comprehensive overview of the market which would be of particular utility during periods of broader market stress.

To conclude, given that assets in passive funds now exceed those in active funds in key global markets[2] – with ETFs the primary driver of this growth – it is no longer tenable that policymakers continue to consider the impact of regulation on ETFs as an afterthought or, worse still, not at all.

Instead, regulation must support investors' access to one of the most significant democratising investment trends of the last 30 years by ensuring appropriate consideration of the specificities of ETFs and passive investing from the earliest stages of policy design.

1. Source: ETFGI, February 2023
2. Source: FT, June 2022

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Are European UCITS and AIF frameworks adapted to investor needs?

The success of EU-based investment funds has been recognized for decades. The first UCITS regulatory framework adopted in 1985 has led progressively to a golden and worldwide label. It was complemented later on by the development of various types of AIFs, following the adoption of the AIFM Directive in 2011.

In terms of facts, the data provided by EFAMA [1] show that assets under management for European funds reached over EUR 19 trillion at the end of 2022. In spite of the recent turbulences on financial markets, it compares favorably to the EUR 15 trillion at end 2018 (+26% in four years). And even in 2022, while the traditional funds invested in capital markets declined, it has to be noticed that some alternative asset strategies registered inflows (e.g. infrastructure funds or private equity funds). Ultimately, it explains why some EU-based asset management companies registered net inflows in 2022 overall [2].

Additional figures show that EU funds definitely answer various investor needs: at EU level, in terms of total Assets under Management, amounts originate on equal terms from Retail (48%) and professional investors (52%). And that answer to investor needs is more and more successful on a cross-border basis: in 2021, foreign clients of EU funds have represented 33% of fund assets, as compared to only 27% in 2017.

This is not surprising:

- For regulatory reasons: up to now, the EU was able to set a comprehensive and progressively harmonized framework which has evolved over time without harming the positive aspects of the previous versions, rightly balancing investor protection and investment returns;
- Due to EU business offer: the underlying assets are global in their nature (equities, bonds, real estate, infrastructure, private equity, etc.), geographies, as well as strategies;
- The structuring of funds can be very diverse, in terms of optimizing the combination between investor needs and profiles, investment strategies, and pace of subscriptions and redemptions among others.

From this investor need standpoint, the recent Regulatory actions by the EC have to be lauded: the targeted review of AIFM and UCITS Directives, as well as ELTIF Regulation, will certainly allow for even more progress in answering investor needs through EU funds while preserving financial stability (e.g. an EU regime for Loan-Originating Funds; wider availability of Liquidity Management Tools; facilitated access to private assets by retail investors through ELTIF 2.0).

To answer investor needs, EU officials must care about preserving the competitiveness of EU managers.

But beyond investor needs, we have also to make clear that EU investment funds are key funders of the EU real economy: European funds owned in 2021 more than 17% of the listed shares issued in Europe, and more than 13% of debt securities (both public and corporate) issued in Europe.

Latest significant step over the last decade: to accompany the decision by Member States and the EC to act on sustainability, EU fund managers have been developing an offer of sustainable funds, as a bridge between the wills of ESG-oriented investors and the need for financing green projects in Europe.

Still, to preserve that critical role of EU fund managers in answering investor needs as well as EU economic and sustainable needs, EU officials must care about preserving the competitiveness of EU investment managers. Even if the role of EU funds has increased within the region, at global level it appears that the market share of Europe (including the UK) has decreased to 31% in 2022, as compared to 38% in 2008 (-7%), to the benefit of Americas (+3%) and Asia (+4%) [3].

This is where EU institutions can play a critical role, with at least two actions in the short term:

- Regarding AIFM/UCITS Review at Levels 1 and 2. We must avoid the costly obligation of new reportings by EU fund managers to National Competent Authorities that our non-EU competitors would not support (i.e. avoiding a new reporting for each of the 33,000 EU UCITS funds, while we already provide the detailed inventory of each fund to Central Banks);
- Regarding the external ESG Data that we have increasingly to buy and make use of (in particular due to regulatory requirements). We urgently need a clear EU Regulatory action on external ESG Data providers (and not only on external ESG Ratings ones): to secure Data reliability for us; to set liability on providers; and to ensure transparency on fee grids. Thus, the EU would comply with IOSCO's Recommendations issued in 2021, which target explicitly both ESG Data Products Providers as well as ESG Rating Providers [4].

Otherwise, EU fund managers would have to bear growing unfair risks and costs, to the ultimate detriment of our investors that we are deeply willing to serve.

[1] Source: EFAMA: "Quarterly Statistical Release", 28 February 2023, and "Asset Management in Europe", 14 December 2022.

[2] For instance, AXA IM registered EUR 17 billion of net inflows in 2022.

[3] Source: International Investment Funds Association.

[4] "ESG Ratings and Data Products Providers", Final Report, IOSCO, November 2021.

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Investor protection: stop patronizing - introduce the safeguards investors want

We can't state that the existing EU frameworks are covering all significant safeguards and investor needs. We've entered into an era where we see more pan-EU financial flexibility, comprehensive digitalization, demographics requiring self-discipline and a higher educated population. The main issue is not that investors don't understand financial products. Investors don't trust products, nor the 'independent' intermediaries. Consequently, huge amounts of investors' savings are dead wood on a savings account washed away by inflation. New and existing companies are hesitant to issue equity capital and still depend on bank loans. The solution is not the introduction of listing requirements easier to comply with; (re-)building trust is what is required.

The capital markets union and retail investment strategy are important improvements if they would deliver, *inter alia* a full inducement ban, harmonized insolvency laws and pan-EU collective redress (compensation for losses due to fraud and intentional non-compliance with EU- and national law and regulation by listed companies and intermediaries). Despite many efforts and progress made, the European rulebook sprouted from building blocks regulating historic economic realities. Consequently, the rulebook is sell-side biased; retail investor protection is fragmented and weak.

Building trust is ever more important. The degree of uncertainty surrounding the global banking environment is doubtless to shake investor confidence, retail investors by no means excepted. Hence, I will not be far off the mark when I predict that maintaining (or: bolstering) banking stability will certainly be at the top of the EU's agenda; and rightly so. However, investor confidence receiving sensitive blows, is precisely a trigger to stress its preeminence in opening financial markets to retail investors. More equity capital, for listed companies and financial institutions, in an economic environment with high inflation and increasing interest rates, is urgently called for.

To garner confidence, ban inducements and introduce pan-EU collective redress.

In directing the focus to the ELTIF review, a preliminary observation is that very few ELTIFs have been created altogether. From the outset, it was feared that retail investors would insufficiently understand the features (lock-up period, and duration), and the risks. Thus, under the original construct, there was the obligation for the manager of the ELTIF to perform the distinct suitability test for retail investors. Whereas the MiFID suitability regime remains (as a mere consequence of ELTIFs classifying under the MiFID), the specific ELTIF-test has now - rightly - been withdrawn.

A closely related aspect is that the specific requirement of advice to be given to retail investors is equally relinquished. Investment advice almost invariably risks bias. In fact, advisers are sellers. There is a fundamental lack of retail access to independent investment services. However, where ELTIFs are concerned, we have difficulty in accepting that to stimulate retail investment, the EU has resorted to lowering investor protection.

Turning to the AIFMD review, here we overall approve the adaptations. Harmonizing the requirements for loan-originating AIFs is the way to go. Especially the way liquidity management-issues concerning loan-originating AIFs are addressed, attracts our scrutiny. AIFMs and UCITS managers may now (temporarily) suspend redemptions. Under the new requirements, such redemptions should strictly be warranted by investors' interests. The connection with the issue of investor confidence is blatantly evident. There are bad experiences stemming from suspension of redemptions, whether they be excused by the corona pandemic or otherwise. Suspending redemption is, *per se*, likely to trigger nervousness.

The matter of the energy transition gains prominence by the day. The IPPC Press Release of 20 March 2023 is broadly taken as stating the evident truth that keeping warming to 1.50C is a mere illusion. With that in mind, financing the transition, and, hence, redirecting and attracting capital to 'sustainable investments', gains urgency by the minute. This brings me to the spate of asset managers having had to 'reclassify' their funds from 'Article 9 funds' to 'Article 8 funds'.

Morningstar estimates that fewer than five per cent of Article 9 funds target sustainable investment exposure between 90 per cent and 100 per cent. The downgradings result from new regulatory guidelines and in no way reflect changes in investors' strategies. If anything, this is a reputational risk for the asset managers involved. But, importantly to European Investors, it is a harsh blow to investor confidence. The kind of blow one could do without. Reliability of Article 9 funds is vital for the impact economy.

To conclude, if the EU-rulebook were to cover the main retail investor needs – ever more so in the actual precarious situation undermining confidence – it must garner confidence, trust investors' preferences, ban inducements and introduce pan-EU collective redress.