

BETTER FINANCE RESEARCH PAPER ON DETRIMENTAL EFFECTS OF “INDUCEMENTS”*

** Commissions and other remunerations from third parties to distributors or brokers for selling investment services*



EVIDENCE & ARGUMENTS FOR BANNING INDUCEMENTS IN RETAIL INVESTMENT SERVICES

“Investment advice is never free of charge. Whether directly or indirectly, the client always pays for it.”

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EXECUTIVE SUMMARY

BETTER FINANCE screened available evidence (literature, surveys, experiments, and statistical data) comparing the impact of allowing the receipt of “*inducements*” by distributors or brokers of “retail” investment services and products, versus banning it.

Two jurisdictions in Europe already banned the receipt of commissions for the distribution of retail investment products: the United Kingdom, since 2012, and the Netherlands, since 2014. In these two jurisdictions only the *fee-based model* exists, whereas in the rest of the 26 EU Member States (EU27), it coexists with the *commission-based model*.

“*Inducements*” designate remunerations, such as commissions or kickbacks, paid by financial firms to distributors, brokers, or investment advisors for recommending a service or product to “retail” clients. However, these are not meant to remunerate advice, but in fact selling of financial products.

In a fee-based model, the advisor is remunerated directly by the client through a fee, generally upfront. In a commission-based model, distributors and brokers are paid through commissions by product manufacturers or other service providers, which are clawed back from the client through annual costs.

This report by BETTER FINANCE aims to support EU authorities in their considerations of a **ban on “inducements”** in retail distribution channels across all financial market sectors. Considering the European Commission’s upcoming **EU Strategy for Retail Investors**, which has the objective of ensuring “*bias-free advice and fair treatment*” for retail investors, BETTER FINANCE sees sales commissions as a key obstacle to reaching the aforementioned objective.

The most relevant findings of BETTER FINANCE’s independent research are presented below.

LITERATURE

Studies on the subject indicate that inducements (*commissions, retrocessions, kickbacks, rebates, etc*) inherently generate conflicts of interest and can lead to the mis-selling of financial products, suboptimal asset allocation, and poorly performing investment products.

The more widespread the use of inducements, the more product manufacturers compete on the size of the commissions paid, rather than on the performance of products. Research shows that conflicted advisers - those who are dependent on commissions - *can* be up to six times more likely to give non-compliant or unsuitable advice. What’s more is that commissions make fund sales far less sensitive to past performance: no matter how poorly a fund has performed in the past, commission-based funds can still sell many units due to biased distributors pushing for them. BETTER FINANCE research found a study showing that, for every 1% paid in commissions, investors stood to lose 1.4% in gross returns (that is, before the deduction of fees); other studies showing a decrease in net returns of 0.5% for every 1% of commissions.

BETTER FINANCE awaits the publication of the European Commission’s own report on disclosure, inducements, and suitability rules for retail investors.

INDUSTRY REPORTS FAVOURING THE COMMISSION-BASED MODEL

Two carefully worded reports commissioned by asset managers and distributors use smoke and mirrors to obfuscate the negative effects of commissions, twisting certain findings to fit their false narrative, warning of the dangers of banning such a model. **BETTER FINANCE challenges the findings of this industry report and stresses the following:**

- both reports allege that a commission ban would negatively affect the entire EU retail investments market, even though their scope covers just 9% of it;
- evaluation reports in the UK and Netherlands found no “advice gap”, but rather the contrary, and independent investment advice (*fee-based model*) is available for retail investors for as little as €1 in investable assets;
- in the Netherlands, since the inducements ban, retail clients have benefitted from a wider, more innovative and simpler range of products and services;
- 3 out of 4 consumers and 9 out of 10 companies are clients of independent advice firms in the Netherlands;
- the report insists on comparing the total cost of ownership between the two models, without:
 - taking into account insurance-based investments and pension products, representing 34% of EU households’ financial savings;
 - highlighting the detrimental effect of costs on net returns;
 - omitting that, in fact, the culprit with conflicted distributors is the selection bias, pushing investors to riskier or poorly performing products;
- the non-public report claims that commissions do not prevent access to third-party products, whereas evidence from the European Commission study on distribution channels of retail investment product clearly highlights the contrary: “*non-independent advisors at banks and insurance companies almost exclusively proposed (one or a selection of a few) in-house products*”¹;
- robo-advisors are subject to the same rules and supervision as traditional, human advisors, and must meet the same quality standards (*suitability* of the investment advice), a fact the reports conveniently omit.

STATISTICAL DATA

Between 2012 and 2019, Dutch households were amongst those to put away the least of their savings into currency and deposits and invested ten times less in investment funds compared to the EU26 average (excl. NL), according to Eurostat data. Dutch retail savers were among the very few to divest from life insurance products.

Data on the costs of UCITS (mutual investment funds) shows that on average 38% of all costs paid by investors are pocketed by distributors and advisors. According to figures published by the European Securities and Markets Authority (ESMA), among the cheapest investment funds in Europe were sold in the Netherlands and in the UK, where inducements are banned.

Thanks to these lower costs, the erosion of the long-term nominal gross returns for EU investors in Netherlands-based UCITS was 36% lower compared to the EU average over the past 10 years (2010-2019). BETTER FINANCE reiterates its principle finding on the correlation between cost and performance of EU Equity Retail UCITS: “*the more you pay, the less you are likely to get*”.²

¹ See footnote 52.

² BETTER FINANCE Press Release, *The More You Pay, The Less You Are Likely To Get* (20 June 2019), available at: <https://betterfinance.eu/publication/the-more-you-pay-the-less-you-are-likely-to-get/>; see the report BETTER FINANCE, *Study on the*

Adding further evidence, EIOPA's Thematic Review on inducements in insurance markets found that:

- 81% of insurance undertakings³ received inducements in 2015, collecting a total⁴ of €5.2 billion in inducements in 2015, 21.7% more than in 2014;
- 63.4% of this amount is made up of trailing commissions, i.e., commissions paid as long as the client holds the insurance policy;
- inducements favour riskier products: equity funds pay twice the amount of inducements than bond or money market funds do (0.54% vs 0.24% or 0.25%);
- the median value of inducements collected by the insurance distribution market represented 0.56% of assets under management.

A *clean share class* refers to categories of units in mutual investment funds for which distributors (sellers, advisers) do not receive commissions. As such, clean share classes tend to be significantly cheaper than other share classes in a fund.

Data from the French unit-linked market (where inducements-free supports, such as clean share classes and ETFs, represent less than 3% of contracts sold in all distribution channels) shows that inducements double the fixed costs paid by clients by adding between 61 bps (0.61%) and 77 bps (0.77%) to the costs of investment products. Over an average holding period, this can cost up to 15% of the gross return of retail investors.

Evaluation of the UK and the Netherlands ban on inducements

A report commissioned by the Dutch Ministry of Finance found that, after banning inducements, Dutch execution-only clients saved €300 million thanks to a threefold decrease in prices (0.25% vs 0.75%). At the same time, the products offered to Dutch retail investors became simpler and the palette of services more diversified and innovative, thereby avoiding the “advice gap” entirely.

In the UK, initial studies found no evidence of an “advice gap” either after banning inducements, but rather an excess advice offer (vs demand). The 2020 evaluation of the inducements ban (Retail Distribution Review) found that an extra 1 million UK consumers accessed advice in 2020 compared to 2017, whereas only 10% of consumers surveyed stated that they couldn't afford financial advice. The majority (67%) of consumers who did not receive advice thought they did not need it, while 72% of those who had received advice (72%) were satisfied with the serviced offered.

BETTER FINANCE Survey of individual investors and member organisations

A survey by BETTER FINANCE found that the prevention of conflicts of interests and non-independent advice are two of the three most pressing issues worrying BETTER FINANCE members. Individual investors, who are far less aware of the issues posed by inducements and conflicts of interests, still responded significantly that the quality of advice must be improved.

Correlation Between Cost and Performance in EU Equity Retail Funds (June 2019), available here: <https://betterfinance.eu/wp-content/uploads/BETTER1.pdf>.

³ Participating in the EIOPA survey; see footnote 95 for references.

⁴ Estimated based on the total data from the survey; see footnote 95 for references.

POLICIES SIMILAR TO AN INDUCEMENTS BAN (AUS, CAN, USA)

In Canada, the CSA⁵ has already banned embedded commissions (for mutual funds) and trailing commissions for execution-only services. In the US, the SEC *Best Interests Regulation* imposes an indirect ban on inducements since disclosure of certain conflicts of interests is insufficient to address the detrimental effects caused to retail clients. In Australia, with the exception of life insurance products, investment advisors are not allowed to receive commissions for superannuation⁶ products and ordinary investments.

POLICY RECOMMENDATIONS

Introduce “independent advice” under IDD (the European Insurance Distribution Directive) and other sectoral legislation

The same distinction should be made between independent and non-independent advice, execution-only services and portfolio management, for all other retail investment product markets.

Ban commissions for independent advice, execution-only services and portfolio management in all EU retail investment markets

Professionals providing independent advice, execution-only services (particularly reception and transmission of orders) and portfolio management, regardless of the EU retail investment product concerned, should not be allowed to receive and retain commissions.

Introduce a definition for “acting in the client’s best interest”

The general duty of care should be defined as “*the ultimate aim of delivering value for money from a financial instrument at the end of the clients’ investment horizon or desired holding period*”. In this sense, a product or service would deliver value for money when its characteristics, particularly regarding cost and performance in relation to an appropriate benchmark, enable it to achieve its investment objectives which must be aligned with the profile and needs of the consumer.

Introduce a definition of “conflicts of interest”

In our view, the definition should take into account that conflicts of interest “*arise when the investment firm, including its staff, has or may have financial or economic interests, both directly or indirectly, to act or take a decision that is contrary to the interest of the client, either short or long-term, irrespective of whether the act or decision is contended or taken and whether a damage is caused*”.

⁵ Canadian Securities Administrators / Autorités canadiennes en valeurs mobilières.

⁶ Superannuation (or “super”) products generally are collective occupational pension funds.

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Background information

When investing, an individual can directly instruct a broker what to invest in (*execution-only*), ask for an investment offer, or seek a recommendation about investments. Under EU law, the latter option is performed by investment advisers, who can be *independent* or *non-independent*.

If an investment advisor does not receive any form of remuneration (monetary or non-monetary benefits⁷) from third parties when making a recommendation to a client (investor), then he is considered *independent*. Vice-versa, if third parties (such as product manufacturers) remunerate distributors for recommending a certain investment service or product, they are considered *non-independent*.

Note: In BETTER FINANCE's view, a non-independent "advisor" is, in fact, a seller of investment services and products. The seller can be part of the services provider or manufacturer of investment products (closed or in-house distribution) or can be tied to one or more providers/manufacturers through the selling commissions received from the latter.

These remunerations are referred to as *inducements* under MiFID II⁸ and IDD,⁹ but are more commonly called commissions, retrocessions or kickbacks. The debate around inducements is heated around the world due to the question of whether inducements (in the retail sector) should be allowed or prohibited:

- on one side, some stakeholders and authors argue that paying (as a product manufacturer) commissions to investment advisors to recommend a certain product does not constitute a conflict of interest, improves the quality of advice and also allows access to this professional and competent service for those savers that could not normally afford it;
- on the other side, other voices claim that inducements in essence generate a conflict of interest and a breach of the law, can lead to mis-selling, affect the level of financial literacy of non-professional savers, and produce frictions in the market (information asymmetry, over-reliance on certain types of products).

At the same time, investment advisers are not the only ones to receive inducements.¹⁰ Another practice that sparked much debate¹¹ is the receipt of inducements by brokers to direct client orders to certain execution venues. This is referred to as *payment for order flow* and seems to be at the core of many online brokerage platforms that offer "zero trading fees" or "zero commissions".¹²

For the purpose of this paper, BETTER FINANCE will only analyse the two abovementioned practices that give rise to conflicts of interests, i.e., **remunerations received for the provision**

⁷ With the exception of minor non-monetary benefits that do not affect the impartiality of the service provided.

⁸ Markets in Financial Instruments Directive (E 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>.

⁹ Insurance Distribution Directive, 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>.

¹⁰ For several examples of the different types of inducement practices, see Lars Frölich, Dr Jörg Schneider, 'Inducements - Ban with an exception: tighter rules for commissions and other benefits' (24 September 2018) BaFin – Consumer protection topics, available at: https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2018/fa_bj_1808_Zuwendungen_en.html;jsessionid=49A3A525C96A362CF6EF14035E65EAE5.1_cid501?nn=8813520.

¹¹ See BETTER FINANCE Press Release "GameStop Case Highlights Discrimination of Retail Investors in Stock Markets" (4 March 2021), available at: <https://betterfinance.eu/wp-content/uploads/PR-GameStop-highlights-Discrimination-of-Non-professional-Investors-in-Stock-Markets-04032021.pdf>.

¹² see Aldo Sicurani, 'Bourse: Zero commission ne veut pas dire zero couts' (December 2020) Inform@ctions – Magazine de la F2iC, p. 4, available at: <https://www.f2ic.fr/ffci-portal/custom/module/cms/content/file/Informations/informations-n67-12-2020.pdf>.

of investment advice and directing order flows to execution venues. Throughout this paper, several key concepts (from financial jargon or applicable EU law) are frequently used and, for purposes of clarity, are described in the table below.

Key concepts

Advised services

When an intermediary offers or advises a client to perform a certain investment service (e.g., investment advice), or otherwise when the client does not expressly solicit the service.

Independent advice

Investment advice qualifies as independent when the advisor is paid only by the client, or another person on behalf of the client. In other words, when the advisor does not receive remunerations from third-parties for the service provided to the client.

Payment for order flow

Remunerations (inducements) paid by operators of order execution venues (e.g. market makers) to a broker for directing transaction orders to the

Trailing “inducements”

These are remunerations (commissions, kickbacks, rebates, etc.) paid continuously and as long as the retail client holds the security or investment.

Commission-based model

In the commission-based model, distributors and brokers are paid through commissions by product manufacturers or other services providers, which are clawed back from the client through annual costs.

Execution-only services

When a client expressly instructs a financial intermediary to provide a service (e.g., to execute a trading order) without being proposed or advised beforehand by the intermediary.

Inducements (commissions, kickbacks)

Remunerations (monetary or non-monetary, with the exception of minor non-monetary benefits) paid by third parties, not on behalf of the client, to the intermediary for providing a certain service to the client (e.g. recommending a certain product).

Best execution

Brokers are obliged (Art. 27 MiFID II) to endeavour to “execute orders on terms most favourable to the client” and “obtain the best possible result”.

Fee-based model

In a fee-based model, the advisor is remunerated directly by the client through a fee, generally upfront.

BETTER FINANCE response to the reports concerning the fee-based and commission-based distribution models

In light of the heated debates regarding how to best “ensure *bias-free advice*” – a key priority for the European Commission in shaping its EU Strategy for Retail Investors¹³ - two reports¹⁴ produced for entities from **the asset management industry and commission-based distributors**¹⁵ circulate half-truths, exaggerated or misleading statements about the commission-based distribution model.

The reports highlight that the commission-based model is far more beneficial for retail investors and that it should therefore be preserved. Amongst others, the reports claim that:

- “where inducements have been banned, no investment advice is provided to retail investors with assets under €100,000”;
- “the inducements ban has shrunk the access to investment advice for mass retail clients”;¹⁶ or
- “A ban on inducements leads to an advice gap and lower participation in the capital markets”.¹⁷

BETTER FINANCE analysed these two reports and issued its opinion and challenges to their findings.

Discrete dissemination to public authorities: To begin with, one of the reports is not publicly available and cannot be found through online searches, nor on the websites of the 18 participating associations.¹⁸ It seems that it was intended to be disseminated discretely by those who commissioned it, away from public eyes, to be used in lobby meetings with EU decision-makers and other stakeholders; (un)fortunately, BETTER FINANCE obtained a copy of this non-report, but cannot disclose the authors or those who paid for it to be produced.

The reports are not independent: in addition, **the reports are not produced independently** from that part of the financial services industry that **uses and benefits from the commission-based model**. As stated in the non-public report’ (hereinafter CBM report) disclaimer, “our work has been carried out and our report has been drafted in such a way as to meet the specific requirements of our client”.¹⁹ Second, the CBM report mentions that the data is collected from “*questionnaires sent to the financial entities of the countries participating in this Study, interviews and from other available public sources*”,²⁰ further highlighting that:

- online brokers and “banks that provide access to financial markets and non-complex financial products through execution and RTO services” **have been excluded from the report**.

¹³ Which could imply more restrictions – or a ban on commissions, rebates, kickbacks, or other types of remunerations from third-parties in the distribution channels of retail financial products – see European Commission, *Consultation Document: A Retail Investment Strategy for Europe* (3 August 2021), available at:

https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/2021-retail-investment-strategy-consultation-document.pdf; see BETTER FINANCE’s response to this consultation here: <https://betterfinance.eu/publication/better-finance-response-to-the-european-commissions-public-consultation-on-the-eu-strategy-for-retail-investors/>.

¹⁴ One of the reports was made public, see KPMG, *The Future of Advice: A comparison of fee-based and commission-based advice from the perspective of retail clients – Whitepaper* (November 2021), available at: <https://die-dk.de/themen/pressemitteilungen/kpmg-studie-provisionsverbot-wurde-breite-bevolkerungskreise-von-finanzberatung-ausschliessen/>; hereinafter “Advice Whitepaper”.

¹⁵ By industry, we refer to the product manufacturers and the distributors who participated at the study, namely 18 associations from the United Kingdom, France, Spain, Italy, and the Netherlands, and three other from Germany.

¹⁶ CBM Report, p. 6.

¹⁷ Advice Whitepaper, p. 19.

¹⁸ We are referring to the one that concerns the Spanish, French, and Italian markets.

¹⁹ CBM Report, p. 98; the second, public report, mentions that it was produced “on behalf of” three industry associations from Germany.

²⁰ CBM Report, p.5.

- in Italy and Spain (out of the three countries without a ban analysed) “*alternative distribution models (e.g., via independent consultants)*”²¹ **have been also excluded**,
- nor were “*investment firms (“Sim”) and the management companies (the Italian “SGR”) which are authorised to provide portfolio management and investment advice service*”²² included for Italy.

Equally, the public report highlights that data on ongoing charges and fees was collected from ten banks domiciled in Germany, with no further mention on data sources, meaning that online brokerage platforms, independent advisors, and robo-advisors were not included. What is more, the public report specifies that “*ETFs were excluded from the data collection, as they are not relevant for inducements*”.²³

By excluding the competitors to the commission-based model, the report paints a truncated reality of distribution channels for financial products, having the potential to blindsight decision-making bodies into maintaining a business practice that is, in BETTER FINANCE’s view, very detrimental for retail investors.

A very narrow and minority scope seriously undermines the validity of most findings and conclusions: Second, both reports exclude the vast majority of the financial savings held by EU27 households, especially insurance-based investment products (IBIPs), personal pensions and pension funds. The report focuses only on a part of the distribution of retail investment funds and retail structured products,²⁴ i.e., a small minority of retail financial savings, whereas the public report also excludes ETFs as being “*irrelevant*” for inducements.

Table 1. Household financial savings - 2020						
	EU27	DE	ES	FR	IT	NL
Banking products	32.2%	40.3%	41.8%	28.4%	33.1%	16.1%
IBIPs and pensions	33.6%	35.6%	16.7%	36.3%	24.9%	68.8%
Direct securities	22.1%	13.2%	24.1%	23.2%	26.1%	10.5%
Investment funds	9.0%	10.5%	14.6%	4.8%	14.8%	2.9%
Loans	0.3%	0.0%	0.0%	0.2%	0.2%	0.1%
Derivatives	0.02%	0.00%	0.12%	0.00%	0.02%	0.01%

Source: Own composition based on Eurostat data, 2020; direct securities comprise debt securities and equities (F3+F51); IBIPs and pensions comprise insurances, standardised guarantees and pensions (F6), derivatives represent financial derivatives and employee stock options (F7), banking products represent currency and deposits (F2);

As far as retail funds are concerned, the report also excludes their distribution via insurance-regulated products, which in many EU Member States represents the majority of retail-owned investment funds (in an economic sense). For example, for France, the report excludes 62% of retail investment funds that are sold to individual savers via unit-linked insurance regulated products (life insurance and personal pensions mostly). One serious consequence of this exclusion of the vast majority of commission-based retail investment products by this report, is its massive underestimation of the total cost of ownership (TCO) for EU retail investors (see for example the French case).

Smoke and mirrors on the “total cost of ownership”. The report insists on the idea that the total cost of ownership is similar between fee-based (independent) and commission-based (non-independent) distribution model, which is not true, as shown, for instance, by the case of the retail distribution of funds in France, with partial costs already amounting to the double

²¹ CBM Report, p. 29.

²² CBM Report, p. 29.

²³

²⁴ CBM Report, p. 17.

of the “TCO” mentioned in the pro-kickbacks report. The report further argues that “for low investment amounts, the Commission-based model can provide for a service where the Fee-based model does not”. In addition, the report claims that the total cost of ownership (TCO) “borne by investors does not depend on whether the intermediary is remunerated via commissions or fees”.²⁵ Accordingly, the report calculates TCO as the sum of the product costs and the related services costs.²⁶

Generally, this presentation of the TCO creates the appearance that retail investors end up paying the same in both models, since the calculations presented in the report omit a large part of the retail investment market and concern only directly held retail investment funds. As shown for the French case (below), the majority of French households invest in mutual funds via unit-linked contracts, adding the insurance wrapper fees on top of the TCO (as calculated in the report). Therefore, the TCO on the larger part of the financial portfolios held by EU households (packaged products) are likely to be much higher than what is presented in the CBM report for the commission-based model and higher than the TCO for the fee-based model.

No analysis whatsoever of the other major issue with the kickbacks model: its negative impact on long term performance of EU savings. The CBM report entirely omits the biggest issue arising from the commission-based distribution model: it lacks any mention of the very negative impact of inducements, and the conflicts of interest it generates, on the long-term performance of the savings products sold to EU citizens.

BETTER FINANCE analysed the correlation between cost and performance of EU Equity Retail Investment Funds and found that the higher the costs, the poorer the performance of the fund:

“an increase in charges by 100 basis points (or 1%) would on average reduce the mean excess return by 45 basis points (0.45%). This magnitude ranges between 0.7 basis points (0.07%) up to 88 basis points (0.88%).”²⁷

Allegations on the inaccessibility of advice under a high threshold. Although the report is carefully worded, it gives the first impression that **investment advice** is available only for wealthy households, with assets of at least €100,000. This is done through misleading statements in the *Executive Summary*, which are worded differently from, and are not fully supported by, the analysis part of the report.

To begin with, the report states that “*where inducements have been banned, no investment advice is provided to retail investors with assets under €100,000*”, and that “*the inducements ban has shrunk the access to investment advice for mass retail clients*”.²⁸ Verifying the analysis for both countries where commissions have been banned (UK and the Netherlands), we find that:

- I. In the case of the UK, the report probably²⁹ extrapolates from the findings of the Financial Conduct Authority (FCA) to conclude that “*A significant part of the United Kingdom retail clients does not have access to investment advice*”,³⁰ which is conveniently derived from the finding

²⁵ CBM Report, p. 6.

²⁶ CBM Report, p. 19.

²⁷ BETTER FINANCE, *Study on the Correlation Between Cost and Performance in EU Equity Retail Funds* (June 2019), p. 16; available here: <https://betterfinance.eu/wp-content/uploads/BETTER1.pdf>; The study is performed on a sample of funds and over a time horizon, see the methodological notes.

²⁸ CBM Report, p. 6.

²⁹ We do not know for sure, and we could not find it in the report, why or on what data the €100,000 figure is based on.

³⁰ CBM Report, p.

that “*clients that benefit from investment advice have on average over 150 000 (174 662€) of assets under advice*”.³¹

However, the source (FCA report³²) does not conclude that clients with assets lower than £100,000 (or €116,442) do not have access to investment advice, nor has the BETTER FINANCE team found any evidence for such statement. What’s worse, the report produced by the industry later quotes the FCA Report saying that “17% of the United Kingdom adults with 10 000€ to 100 000€ (11 644€ - 116 442€) in investible assets” received investment advice,³³ which contradicts the first sentence of the report. The FCA Report, also used for our evidence gathering exercise, only found that “the average advised customer has over £150,000 of assets under advice”.³⁴

Moreover, the FCA Report actually highlights that consumers who did not receive any kind of formal support (i.e. those with investible assets less than £10,000) may not have wanted or needed support, or may not have been aware of it.³⁵ In this sense, there is a striking difference between the £10,000 figure (for consumers who did not receive any formal support) and the £100,000 figure alleged.

The European Commission’s study of 2018 on retail investment products’ distribution channels across the EU revealed, when analysing the UK market, that the mystery shoppers with £10,000 “were redirected by all the banks and insurance companies to IFAs who indeed accepted to receive them and **did provide advice regardless of the investment amount** (the first meeting is generally free, while subsequent investments made through the IFA are typically subject to a fee, expressed as a percentage of the invested amount).³⁶

Some of the reasons or factors that affect the likelihood of individual, non-professional investors seeking formal investment advice have been investigated by BETTER FINANCE on other occasions. So far and to our best knowledge, **the size of investible assets (wealth) has not been highlighted as a general barrier**.

Indeed, among independent financial advisers or consultants, there are businesses that require a certain minimum investment (e.g., €5,000) since the fee charged to the client may be asset-based. However, this is not a rule or a general case, since some advisers charge hourly or fixed fees for providing advice. Therefore, both in the UK and in the Netherlands, consumers can access independent investment advice for as much as €1 of investible assets.

In addition, BETTER FINANCE researched the UK market for investment advice and found numerous examples of accessible investment advice firms for individual investors, both in terms of robo-advisors and traditional (human) financial advisors.

- II. In the case of the Netherlands, the report highlights that “*nowadays, the minimum threshold of investible assets necessary to benefit from investment advice effectively amounts to an average of 500 000€*”³⁷ based on two sources that **are not public and therefore cannot be verified**. Nevertheless, the report of the Dutch financial supervisory authority (AFM) shows a 43% increase in the use of independent financial advisors between 2014 (when the ban became

³¹ CBM Report, p. 31, quoting the Financial Conduct Authority, *Evaluation of the Impact of the Retail Distribution Review and the Financial Advice Market Review*, December 2020, page 3.

³² Financial Conduct Authority, *Evaluation of the Impact of the Retail Distribution Review and the Financial Advice Market Review*, December 2020, available at: <https://www.fca.org.uk/publication/corporate/evaluation-of-the-impact-of-the-rdr-and-famr.pdf>.

³³ CBM Report, p. 31.

³⁴ FCA Report, p. 3.

³⁵ FCA Report,

³⁶ The European Commission study on “Distribution systems of retail investment products across the European Union – Final Report” Page 33 https://ec.europa.eu/info/sites/default/files/180425-retail-investment-products-distribution-systems_en.pdf.

³⁷ CBM Report, p. 48.

effective) and the end of 2020, i.e. an increase from 21% to 30% of households who sought this mode of investment. This stands to show, if anything, that there is no advice gap in the Netherlands.

In addition, BETTER FINANCE also researched the Dutch market for investment advice³⁸ and found several traditional (human) advisor firms that offer investment advice for a fixed fee or at low minimum investment thresholds.

Moreover, the European Commission's 2018 study on distribution channels in retail financial products across the EU found, concerning the Dutch market and the effects of the inducements ban, that qualifying for advice with independent financial advisers was possible for investable assets considerably lower than €500,000.



Disambiguation

We wish to highlight the difference between the *inaccessibility* of advice, the *unwillingness to pay* for advice and the *propensity to seek* advice among non-professional ("retail") clients.

First, in BETTER FINANCE's experience (research and member input), for many years just a small share of EU households sought formal investment advice to begin with, which can be attributed to several factors such as a lack of trust, low financial literacy, or low investing incentive. Therefore, it follows that statistics indicating low percentages of "retail" investors accessing advised services are normal and not indicative of the negative effects of banning inducements.

Second, the unwillingness to pay for advice is a natural reflex for consumers who have been accustomed to consultations (e.g., through bank branches) or financial advice provided at no apparent upfront cost, without knowing or being adequately informed of the fact that the price for advice will always be paid afterwards (clawed back in annual costs). This is backed up by research showing that many financial services users are unaware that advice, in fact, does not come for free.³⁹

Last, the inaccessibility of advice as an investment service occurs when professionals require a high threshold for the minimum investment, which is an exceptional business model across the EU. Generally, and as expressed in the CBM report as well, *proximity banking* (distribution of financial products through bank services) is the main model in many EU Member States, and it does not generally involve upfront costs (fee-based) since the intermediaries are either in-house (salaried personnel) or distributors receiving remunerations from product manufacturers.

This was also the finding of the European Commission's study on the distribution systems of retail investment products (quoted above) that the average retail investor does not understand the incentive scheme of their non-independent advisor and frequently perceives that this type of advice is free. Interestingly, and unsurprisingly, some experiments suggest that *"when investors became aware of a conflict of interest of their advisor (non-independent advice), they were substantially less willing to pay for advice or to follow a recommendation to invest"*.⁴⁰

Allegations on "added value services". The report claims that a prohibition for intermediaries to receive remunerations (commissions, kickbacks, retrocessions) from third parties will exclude

³⁸ Random selection of registered investment advisors or investment advice firms based on the Register of the Dutch Financial Markets Authority (AFM), <https://www.afm.nl/en/professionals/registers/vergunningenregisters/financiele-dienstverleners?Filter1=3&KeyWords=#results>.

³⁹ Nadia Linciano, Valeria Caivano, Daniela Costa, Monica Gentile, Paola Soccorso, *Report on Financial Investments of Italian Households Behavioural Attitudes and Approaches* (December 2020) CONSOB, Statistics and Analyses, p. 48, available at: <https://www.consob.it/documents/46180/46181/rf2020.pdf/ccfe7ad2-810f-4490-bd7e-413daa24c391>; see also a research quoted by BEUC showing that a minority of consumers read the information about cost and services thoroughly – BEUC, *The Case For Banning Commissions in Financial Advice* (2019) BEUC-X-2019-046, p. 7, available at: https://www.beuc.eu/publications/beuc-x-2019-046_the_case_for_banning_commissions.pdf.

⁴⁰ The European Commission study on "Distribution systems of retail investment products across the European Union – Final Report" Page 103 https://ec.europa.eu/info/sites/default/files/180425-retail-investment-products-distribution-systems_en.pdf.

clients from receiving “additional protections provided by added value services”⁴¹ as part of the quality enhancement requirement. The examples provided for these “added value services” include:

- “suggested optimal asset allocation for the client based on its profile”
- “global assessment of the client’s personal situation”
- “guided access to more tailored financial instruments”
- “annual suitability assessments”.⁴²

In BETTER FINANCE’s view⁴³ - pursuant to the MiFID II framework (Art. 24(9) and the implementing Art. 11(2)(a) MiFID II DA), read in conjunction with ESMA’s clarifications on the quality enhancement tests - the aforementioned examples **should not be considered additional services, nor of such nature as to enhance the quality of the advice received**. On the contrary, we believe that **these are legal requirements for the investment service** (investment advice, Arts. 4(1)(4) and Art. 25(2) MiFID II) **to be valid in the first place**.

In particular, through an update to its Q&As on investor protection topics,⁴⁴ ESMA clarified that the additional or higher-level service must “go beyond aspects of the firm’s organisation or services that are legally required or that can be considered as essential for its functioning”.⁴⁵

In other words, the additional service must not amount to an obligation that is part of the service or to fulfilling a legal requirement. Furthermore, the added value or higher quality services must not be “legally required nor essential for the firm’s functioning”, or the clients would otherwise have to pay to receive these services.⁴⁶ For instance, providing “access to a wide range of suitable financial instruments, including an appropriate number of instruments from non-affiliated third-party providers” cannot be considered to fulfil the requirements of Art. 24(9) MiFID II.⁴⁷



Disambiguation

Any investment advice must be **suitable** for the client, i.e., the transactions and financial instruments recommended must be aligned with the investment objectives, risk profile, ability to bear losses, financial situation, knowledge and experience of the client (Art. 25(2) MiFID II).

If an advisor receives commissions from third parties (non-independent advice), these commissions must enhance the quality of the service provided and not impair with the duty to “act honestly, fairly and professionally in accordance with the best interest of its clients” (Art. 24(9) MiFID II).

Enhancing the quality of the service can either be done by providing an additional service (such as “free access to trainings, seminars or conferences”) or a higher-level service (such as “access to staff bringing specific expertise on special matters such as tax or inheritance law”⁴⁸) – Art. 11(2) MiFID II DA.

The commission-based model does de facto prevent access to non-commissioned products.

The report claims that “The Commission-based model does not prevent access to third-party products”.⁴⁹ To begin with, the research commissioned by the European Commission in 2018

⁴¹ CBM Report, p. 7.

⁴² CBM Report, p. 7.

⁴³ In this sense, BETTER FINANCE sent an official request for clarification to the EU supervisor on securities markets, ESMA, which is the author of the Q&As BETTER FINANCE quoted above; to the date of publication, BETTER FINANCE did not receive an official response.

⁴⁴ ESMA Q&As on MiFID II and MiFIR investor protection and intermediary topics (29 March 2021) ESMA35-43-349, the section on *Inducements*, pp. 105-115. Hereinafter “ESMA Q&As”.

⁴⁵ ESMA Q&As, p. 113.

⁴⁶ ESMA Q&As, p. 113.

⁴⁷ ESMA Q&As, p. 113.

⁴⁸ ESMA Q&As, p. 113.

⁴⁹ CBM Report, p. 7.

on distribution channels for retail financial products already confirmed the **contrary**: the overwhelming majority of non-independent human advisors only propose in-house products and third-party products are offered only as a rare exception,⁵⁰ which makes BETTER FINANCE question the convenient finding in the CBM report that “*The proportion of intermediaries that systematically offer a product range that includes **third-party products** amounts, in the sample analyzed, to between 65% and 90%*”.⁵¹ According to the mystery shopping exercise conducted by the authors for the European Commission study, these conclude that:

*“In each Member State, non-independent advisors at banks and insurance companies almost exclusively proposed (one or a selection of a few) in-house products. Conversely, 3rd party products (e.g. the few ETFs offered were 3rd party products) were only proposed in very rare cases”.*⁵²

Unfortunately, there are no mandatory disclosures on the total “inducements” (commissions, retrocessions, kickbacks) received by distributors in the commission-based model, thus evidence on their size or nature is difficult to find. Some scarce evidence identified by BETTER FINANCE shows that certain non-independent investment advisors had above 9,800 share classes for which commissions were received, or in other instances above 65% of the financial instruments out of the total offered.

Disambiguation

Non-independent advisors must disclose to the client, before providing the advice service, whether it is done on an independent basis or not. In the latter case, the size, nature, or method of calculation of the commissions, as well as who is paying them must be communicated to the client or potential client.

In this sense, EU law does impose a disclosure obligation on commissions, but a very weak one: the disclosure is made only to the client, on a case-by-case basis, and the distributor is not required to include it in any regulatory reporting to public authorities.

Moreover, as the Advice Whitepaper also mentions, in the fee-based advisory model in the German distribution model, the three types of client remuneration (flat fee, hourly fee, fee as a percentage of investable amount), the model “*is not dependent on product sales*”,⁵³ which clearly highlights, in our view, the absence of other incentives for the advisor to act in the best interest of the client.

Therefore, BETTER FINANCE believes that an investment advisor will be prone to recommend a financial instrument for which it receives commissions, even trailing commissions, from the product manufacturer and not charge the client upfront, rather doing the opposite.

A ban on inducements would not hamper the CMU and green transition. In a careful wording, the report gives the impression that banning inducements (by adopting the fee-based distribution model only) would “*prevent citizens from accessing financial instruments and thus move away from this objective*”), thus hampering the “*enormous capital inflows*” necessary for the “*transition to a green and digital economy*”.⁵⁴

⁵⁰ The European Commission study on “Distribution systems of retail investment products across the European Union – Final Report” page 22, https://ec.europa.eu/info/sites/default/files/180425-retail-investment-products-distribution-systems_en.pdf.

⁵¹ CBM Report, p. 7.

⁵² The European Commission study on “Distribution systems of retail investment products across the European Union – Final Report” page 22, https://ec.europa.eu/info/sites/default/files/180425-retail-investment-products-distribution-systems_en.pdf.

⁵³ Advice Whitepaper, p. 37.

⁵⁴ CBM Report, p. 79.

In our opinion, the development of a Capital Markets Union (CMU) “*That Works for People*”⁵⁵ must be based on a higher direct participation rate of EU households in capital markets, which involves “*access to bias-free advice*”. To begin with, the EU must restore the trust of consumers in financial markets, gradually lost over the past two decades. This cannot be done if one of the probable causes of mis-selling and breaches of investor protection rights, conflicts of interests, are still present in the distribution of retail financial services. Second, the CMU and the economic recovery after the global health pandemic requires large capital inflows in the real economy from EU households. As such, re-directing investors to packaged products that pay commissions to distributors will certainly not help this objective.

“Consumer trust” is not undermined by overemphasis on costs. The report claims that, among the reasons for the low participation rate of European households in capital markets is the “*emphasis put by prominent stakeholders and authorities on the negative impact of costs on the return that retail investors can expect to receive from investment products, while not emphasising the benefits*”.⁵⁶

To begin with, consumer trust in mutual funds is not undermined by the emphasis on costs, rather by the poor(er) real net returns,⁵⁷ cost structures (e.g. performance fees)⁵⁸ and by other breaches of consumer rights,⁵⁹ such as closet indexing,⁶⁰ unfair securities lending practices,⁶¹ or greenwashing.⁶² More generally, financial services and capital markets have ranked among the lowest consumer sectors in terms of consumer trust for almost a decade, reason for which the recent emphasis by prominent stakeholders⁶³ and public authorities⁶⁴ on the detrimental effect of costs on long-term returns cannot be directly linked to this deteriorating consumer trust.

BETTER FINANCE can also be counted among the stakeholders that aim to demonstrate the negative effects of high costs of packaged retail investment products on net returns. BETTER FINANCE agrees that investments in mutual funds or other packaged products can have beneficial effects, particularly in comparison with “investing” via term deposits or not investing at all, but our experience and member input shows that many non-professional savers are being constantly redirected to fee-laden, complex, and poorly performing products overall.

Robo-advisors are a suitable, less conflicted, and cheaper alternative. The report casts doubt over the efficiency, quality, and use of automated investment platforms, which in our view

⁵⁵ https://ec.europa.eu/info/strategy/priorities-2019-2024/economy-works-people_en.

⁵⁶ CBM Report, p. 82.

⁵⁷ Of actively managed funds vs passively managed ones, such as index-tracking ETFs; see ESMA Annual Statistical Reports on Cost and Performance of Retail Investment Products (2019-2021), latest available at: https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1710_asr_performance_and_costs_of_eu_retail_investment_products.pdf.

⁵⁸ BETTER FINANCE Response ESMA Consultation on Costs and Performance Fees in UCITS, <https://betterfinance.eu/wp-content/uploads/BETTER-FINANCE-response-to-ESMA-PC-UCITS-Guidelines-on-performance-fees-for-website.pdf>.

⁵⁹ BETTER FINANCE, *A Major Enforcement Issue: The Mis-selling of Financial Products* (April 2017) available at: https://betterfinance.eu/wp-content/uploads/publications/Misselling_of_Financial_Products_in_the_EU_-_Briefing_Paper_2017.pdf.

⁶⁰ See BETTER FINANCE 2017 Closet indexing report (<https://betterfinance.eu/article/better-finance-replicates-and-discloses-esma-findings-on-closet-indexing/>); see BETTER FINANCE’s 2019 *Benchmark Disclosure Compliance Report* (<https://betterfinance.eu/publication/at-least-619-ucits-equity-funds-found-in-breach-of-key-eu-disclosure-rules-as-poor-enforcement-prosper-in-several-key-countries-2/>); see SCM Direct, *Closet Indexing: The UK Epidemic Continues* (February 2015) SCM Direct, available at: <https://scmdirect.com/wp-content/uploads/2019/06/Closet-Indexation-Epidemic-Continues-Report-February-2015-SCM-Direct.pdf>.

⁶¹ See BETTER FINANCE, *Efficient Portfolio Management Techniques: Attribution of profits derived from Securities Lending by UCITS Exchange-Traded Funds* (May 2019), available at: <https://betterfinance.eu/publication/fund-research-efficient-portfolio-management-techniques-attribution-of-profits-derived-from-securities-lending-by-ucits-exchange-traded-funds/>.

⁶² SCM Direct, *Greenwashing: Misclassification and Mis-selling of Ethical Investments* (November 2019), available at: <https://scmdirect.com/wp-content/uploads/2019/11/SCM-Direct-Greenwashing-Report.pdf>.

⁶³ See BETTER FINANCE, *Study on the Correlation Between Cost and Performance of EU Equity Retail UCITS* (2019), available at: <https://betterfinance.eu/wp-content/uploads/BETTER1.pdf>.

⁶⁴ ESMA Annual Statistical Report on the Performance and Cost of Retail Investment Products in the EU (April 2021) ESMA50-165-1710, available at: https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1710_asr_performance_and_costs_of_eu_retail_investment_products.pdf.

(BETTER FINANCE) represent a powerful disruptive trend and are good alternatives for traditional, human-based investment advice.

The report contends that the human intervention behind automated investment platforms takes the form of “*client support*” which is not subject to the “*stringent EU and national requirements in terms of qualifications, training, procedures including at least an annual internal or external review of staff members’ development and experience, controls and internal records with respect to the knowledge and competence of staff providing relevant services to clients, as well as responsibility*”.⁶⁵

First off, BETTER FINANCE has been analysing automated investment platforms for 6 years now, also performing mystery shopping to evaluate whether robo-advisors are a suitable alternative for traditional, human advisors.⁶⁶ EU law took a technology-neutral approach towards the regulation and supervision of robo-advisors, meaning that these platforms are subject to the exact same requirements as human advisors. Whether through artificial intelligence or not, financial advice under MiFID II and IDD must be suitable, with all the obligations that flow from this. In terms of qualifications, competence, training etc, those who design and implement the algorithms of robo-advisors are subject to the same rules as human-advisors, whereas “*client support staff*” is not subject to these “*stringent EU and national requirements*”, not for human advisors, nor for robo-advisors.

The wording of this section of the report gives the impression that traditional advisors are fit to deliver the service of investment advice, whereas artificial intelligence is not, to which we retort that – to our knowledge – none of the mis-selling scandals that erupted, both in the EU and US, in the past decade originated with robo-advisors. For reasons of fairness, it is true that BETTER FINANCE’s mystery shopping consistently finds divergences in the investment recommendations (asset allocation and future performance) between the different robo-advice platforms for the same investor profiles, which is both worrying and calls for closer supervision by national competent authorities. Nevertheless, the same divergencies could be found between human advisors as well, insofar as we believe our findings in this sense are not representative of the claim that “*suitable advice*” cannot be provided by robo-advisors.

Further, the report claims that “*most robo-advisors are built for self-directed individuals*” and that human advisors are more suitable for those savers that have a lower degree of financial literacy or for those who have “*delicate or complex financial situations*”.⁶⁷ We strongly disagree, based on our own research. FinTech applications, including robo-advisors, target underserved “retail” markets, thus “<<filling the gap>> left by traditional financial institutions”,⁶⁸ particularly by providing a service at low fees,⁶⁹ low investment thresholds,⁷⁰ as well as other advantages such as the perceived objectivity of the algorithm,⁷¹ the (potential) absence of conflicts of interest

⁶⁵ CBM Report, p. 83.

⁶⁶ See BETTER FINANCE’s latest edition of the *Robo-Advice Report*, available here <https://betterfinance.eu/publication/robo-advice-automated-yes-intelligent-not-so-much/>.

⁶⁷ CBM Report, p. 83.

⁶⁸ Ratna Sahay, Ulric Eriksson von Allmen, Amina Lahreche, Purva Khera, Sumiko Ogawa, Majid Bazarbash, Kim Beaton, ‘The Promise of FinTech: Financial Inclusion in the Post COVID-19 Era’ (September 2020) International Monetary Fund, available at: <https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2020/06/29/The-Promise-of-Fintech-Financial-Inclusion-in-the-Post-COVID-19-Era-48623>.

⁶⁹ Some studies show that robo-advisors charge between 1.3% and 1.8% less than traditional advisors: see Gruppo di Lavoro CONSOB, Scuola Superiore Sant’Anna di Pisa, Università Bocconi, Università di Pavia, Università di Roma “Tor Vergata”, Università di Verona, ‘La Digitalizzazione Della Consulenza in Materia di Investimenti Finanziari’ (2019) CONSOB Quaderni FinTech, p. 25, footnote 11 quoting a study from BlackRock.

⁷⁰ A Deloitte report showed that robo-advisors need 52% less Assets under Management to cover the costs per advisor compared to a wealth manager; see Dominik Mouillet, Julian Stolzenbach, Andreas Bein, Ilma Wagner, ‘Cost Income Ratios: Why Wealth Managers Need to Engage with Robo Advisors’ (December 2016) Deloitte GmbH, p. 3, available at: <https://www2.deloitte.com/content/dam/Deloitte/de/Documents/financial-services/Robo-Advisory-in-Wealth-Management.pdf>.

⁷¹ M. Caratelli, G. Giannotti, N. Linciano, P. Soccorso, ‘Financial Advice and Robo Advice in the Investors’ Perception: Evidence from a Qualitative Study’ (6 December 2019) CONSOB Quaderni FinTech, p. 7.

and biases of human advisors,⁷² as well as increased financial inclusion and literacy.⁷³ Moreover, the European Commission study confirms that robo-advisors give individual investors access to inexpensive, simple products like ETFs, contrary to non-independent human advisors whose *“low willingness (...) to propose ETFs to their retail clients may be due to the absence of an incentive scheme, as ETF managers do not pay commissions”*.⁷⁴

Based on our mystery shopping, EU-based robo-advice platforms also provide financial education tools and have sufficiently detailed questionnaires (*suitability*) to account also for complex financial situations or adequately serve first-time investors.

LITERATURE REVIEW

The topic of inducements has been analysed from different angles in specialised literature. For the purpose of this research, BETTER FINANCE focused on papers that approach the topic of inducements from two angles: either focussing on the *effects* that inducements trigger in the distribution process for retail investors or focussing on what do they actually engender, i.e., conflicts of interest.

Conflicts of interest. Early research on conflicts of interest concluded that these *“appear where one is serving two or more interests and put one person in a better position at the expense of others”*.⁷⁵ Researchers also found that many of the recent (since 2000) scandals in the financial industry may have been caused by conflicts of interest because *“agents, who were supposed to provide the investing public with reliable information, had incentives to hide the truth in order to further their own goals”*.⁷⁶ According to the latter, one of the effects of conflicts of interest is information asymmetry and suboptimal allocation of capital in the market,⁷⁷ which is contrary to the purposes of EU financial regulation. Even judicial courts found, at a general level, that *“inducements for distributing investment products are likely to skew incentives”* of the adviser.⁷⁸ Other researchers highlight that conflicted financial advice can trigger low-quality products,

⁷² See Christoph Merkle, ‘Robo-Advice and the Future of Delegated Investment’ (2020) 51 Journal of Financial Transformation, 20-27, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3612986, p. 3, quoting data from Statista 41; Gruppo di Lavoro CONSOB, Scuola Superiore Sant’Anna di Pisa, Università Bocconi, Università di Pavia, Università di Roma “Tor Vergata”, Università di Verona, ‘La Digitalizzazione Della Consulenza in Materia di Investimenti Finanziari’ (2019) CONSOB Quaderni FinTech, p. 68; In addition, Alemanni *et al.* highlighted that *“a strong incentive to pander investor beliefs as pandering induce investors trusting their professional to invest more and at higher fees”*, see B. Alemanni, A. Angelovski, D. Di Cagno, A. Galliera, N. Linciano, F. Marazzo, P. Soccorso, ‘Do Investors Rely on Robots? Evidence from an Experimental Study’ (7 September 2020) CONSOB Quaderni FinTech, p. 25.

⁷³ Ester Faia, Monica Paiella, ‘The Role of Fintech for the Capital Markets Union’ in Ester Faia, Franklin Allen, Michael Haliassos and Katja Langenbucher (eds.), *Capital Markets Union and Beyond* (2019) MIT Press, 189 – 199, 191.

⁷⁴ The European Commission study on “Distribution systems of retail investment products across the European Union – Final Report” page 24, https://ec.europa.eu/info/sites/default/files/180425-retail-investment-products-distribution-systems_en.pdf.

⁷⁵ Statement of Prof. Franklin R. Edwards during the Congressional Hearings of May 13, 14, 18-19, 1981, before the Committee on Banking, Housing, and Urban Affairs of the United States Senate - U.S. Government Printing Office, Washington 1981, page 1780, *apud* Andrew Crockett, Trevor Harris, Frederic S. Mishkin, Eugene N. White, ‘Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?’ (2004) International Center for Monetary and Banking Studies – Geneva Reports on The World Economy 5, 26.

⁷⁶ Andrew Crockett, Trevor Harris, Frederic S. Mishkin, Eugene N. White, ‘Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?’ (2004) International Center for Monetary and Banking Studies – Geneva Reports on The World Economy 5, 26.

⁷⁷ Andrew Crockett, Trevor Harris, Frederic S. Mishkin, Eugene N. White, ‘Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?’ (2004) International Center for Monetary and Banking Studies – Geneva Reports on The World Economy 5, 22; the same opinion is shared by Colaert and Incalza, noting that *“market failures such as information asymmetry and behavioural biases require certain restrictions on laissez-faire capitalism”* in Veerle Colaert, Thomas Incalza, ‘Conflicts of Interest and Inducements in the Financial Sector’ in Veerle Colaert, Danny Busch, Thomas Incalza (eds.), *European Financial Regulation: Levelling the Cross-Sectoral Playing Field* (2020) Hart Publishing, 377 – 394, 377.

⁷⁸ According to author that analysed two decisions of the Swiss Supreme Court in relation to trailer fees and inducements charged to clients in context of portfolio management – see R. Bahar, ‘Accounting to Clients for Trailer Fees and Inducements – The Decision of the Swiss Supreme Court 4A_127/2012 and 4A_141/2012 of 30 October 2012 and its Regulatory Consequences’ (21 December 2012, caplaw.ch), CapLaw-2012-52, available at: https://www.caplaw.ch/2012/accounting-to-clients-for-trailer-fees-and-inducements-the-decision-of-the-swiss-supreme-court-4a_1272012-and-4a_1412012-of-30-october-2012-and-its-regulatory-consequences/.

“poor asset allocation and eventually mis-selling”.⁷⁹ BETTER FINANCE documented available evidence on the pervasiveness of conflicted distribution models in the EU and US markets.⁸⁰ This evidence coupled with the limited financial literacy⁸¹ of non-professional savers and the general unawareness about the cost of advice, particularly the fact that it is never free,⁸² leads to situations where we may find that product manufacturers and service providers end up competing with one another through the commissions and kickbacks paid to distributors rather than through the value for money their products and services deliver to clients.⁸³

A survey based on a large sample of employees in educational institutions (public colleges and universities) in the U.S., concerning retirement planning, concludes that “evidence that broker incentives influence broker recommendations highlights the agency conflict that can arise when financially unsophisticated investors seek advice from intermediaries”.⁸⁴

Furthermore, experiments involving product manufacturers paying commissions to advisers or distributors, resulted in worrying findings. A study⁸⁵ conducted for the Canadian regulatory authority (CSA), found that commissions embedded in fund charges generate several detrimental effects for consumers, such as:

- “advisors push investors to riskier funds”;
- the returns of funds that pay embedded commissions are lower than those who don’t, no matter what return analysis is performed (“raw, risk-adjusted, or after-fees”);
- “higher embedded commissions stimulate sales”;
- “in the absence of embedded commissions, advisors recommend lower cost products”, which indeed perform better than more expensive alternatives thanks to their lower costs;*

⁷⁹ E. R. Restelli, ‘Shaped by the Rules. How Inducement Regulation Will Change the Investment Service Industry’, July 2019, available at: https://www.researchgate.net/publication/328145345_Shaped_by_the_Rules_How_Inducement_Regulation_Will_Change_the_Investment_Service_Industry, p. 641.

⁸⁰ See Restelli ‘Shaped by the Rules. How Inducement Regulation Will Change the Investment Service Industry’, July 2019, available at: https://www.researchgate.net/publication/328145345_Shaped_by_the_Rules_How_Inducement_Regulation_Will_Change_the_Investment_Service_Industry, p. 641, arguing that “with the exception of the Netherlands, the business model in European distributors is mostly based on inducements”; see also J. Burke, A. A. Hung, J. Clift, S. Garber, J. K. Yoong, ‘Impacts of Conflicts of Interest in the Financial Services Industry’ (02/2015) RAND Working Papers, WR-1076.

⁸¹ See OECD, *OECD/INFE 2020 International Survey of Adult Financial Literacy* (2020) available at: www.oecd.org/financial/education/launchoftheoecdinfeglobalfinancialliteracysurveyreport.htm.

⁸² Researchers remarked that “it is also a consistent finding in financial literacy research that investors are ignorant or mistaken about fees that they pay for financial services and products in general (not only advice)” – J. Burke, A. A. Hung, J. Clift, S. Garber, J. K. Yoong, ‘Impacts of Conflicts of Interest in the Financial Services Industry’ (02/2015) RAND Working Papers, WR-1076, footnote 7 on page 7 ; see also Restelli (n 13), who found that “a significant number of clients, indeed, do not know how their advisors are compensated and some of them even believe investment advice is free”, p. 654; see also BEUC, *The Case for Banning Commissions in Financial Advice* (2019) EUC-X-2019-046, available at: https://www.beuc.eu/publications/beuc-x-2019-046_the_case_for_banning_commissions.pdf, where they document that between 5% and 8% of consumers (in an experiment in the Netherlands) read thoroughly the information about costs and fees; see also the Briefing of the Dutch Minister of Finance to the Parliament of the Netherlands concerning the effectiveness of the inducements ban, 32 457, 23 January 2018, *Brief van de Minister van Financiën, Vergaarderjaar 2017-2018*, available at: <https://www.tweedekamer.nl/downloads/document?id=6eba7576-c347-4c73-aaae-74501faaae10&title=Evaluatie%20provisieverbod.pdf>.

⁸³ See also an analysis done on inducements, in general, paid to distributors of services and products to consumers, not limited to financial services – R. Inderst, M. Ottaviani, ‘Competition Through Commissions and Kickbacks’, (2012) 102(2) American Economic Association, pp. 780-809, available at: <https://www.aeaweb.org/articles/pdf/doi/10.1257/aer.102.2.780>.

⁸⁴ J. Chalmers, J. Reuter, ‘What is the Impact of Financial Advisors on Retirement Portfolio Choices and Outcome?’ (9 June 2012) NBER Working Paper 18158, available at: http://www.econ.yale.edu/~shiller/behfin/2013_04-10/Chalmers_Reuter.pdf, *apud* CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions, 10 January 2017, Appendix A, p. 100, available at: https://www.osc.ca/sites/default/files/pdfs/irps/sn_20170110_81-408_consultation-discontinuing-embedded-commissions.pdf.

⁸⁵ Dr. Edwin Weinstein, Phd, ‘Mutual Fund Fee Research’ (2015) The Brondesbury Group, available at: https://www.securities-administrators.ca/uploadedFiles/General/pdfs/Brondesbury%20Mutual%20Fund%20Fee%20Research%20Report_engwr.pdf.

*This finding (cheaper funds outperform more expensive ones) can also be verified in BETTER FINANCE's report on the correlation between cost and performance of EU investment funds. The analysis, performed on 2,086 equity UCITS and AIFs, finds a strong negative correlation between fees and returns.⁸⁶ In other words, "the more you pay, the less you get".

- mis-selling "will likely be diminished" if inducements were to be banned.

A very recent research paper produced by the asset management association in Europe⁸⁷ clearly shows how much investors end-up paying for "distribution costs" when subscribing to mutual investment funds (UCITS). The report finds that "distribution and advice costs represent a sizeable part of the total cost borne by investors".⁸⁸

Table 2. Cost split in actively and passively managed UCITS			
Retail actively managed UCITS			
	Product costs	Distribution/advice	Share split
Equity	1.19%	0.77%	61% - 39%
Bonds	0.85%	0.49%	64% - 36%
Multi-asset	1.07%	0.69%	31% - 39%
All asset classes	1.04%	0.64%	62% - 38%
Retail index-tracking UCITS			
	Product costs	Distribution/advice	Share split
Equity	0.36%	0.21%	63% - 37%
Bonds	0.27%	0.19%	59% - 41%
Multi-asset	n/a	n/a	n/a
All asset classes	0.32%	0.20%	62% - 38%

Source: EFAMA⁸⁹

From the data published by EFAMA above we observe that retail clients in equity UCITS (active and index-tracking) pay between 37%-39% of costs to compensate kickbacks and commissions; the share goes even higher for passively managed bond UCITS (41%). In overall, investors pay more than a third (38%) of all costs paid by retail investors for their funds are clawed back by asset managers to pay their "distributors" kickbacks and commissions.

Conflicts of interest in retail financial services. The receipt of inducements in retail financial intermediation (distribution of products or execution of services) amounts to, in the view of many authors, at least a conflict of interest.⁹⁰ Some also add that conflicts of interest lead to breaches of legal obligations by investment advisors (the fiduciary duties towards their clients),⁹¹ to market underperformance,⁹² and to the mis-selling of financial products.⁹³

⁸⁶ BETTER FINANCE Study on the Correlation Between Cost and Performance of EU Equity Retail Funds (June 2019) BETTER FINANCE, available at: <https://betterfinance.eu/wp-content/uploads/BETTER1.pdf>.

⁸⁷ European Fund and Asset Management Association, see <http://efama.org>.

⁸⁸ EFAMA, *Perspective on the Costs of UCITS: Fund managers only retain 41% of the total cost paid by retail investors* (September 2021) Issue 6, EFAMA Market Insights, p. 7, available at: <https://www.efama.org/sites/default/files/files/Market%20Insights%20Issue6%20costsUCITS.pdf>.

⁸⁹ *Ibid*, p. 6.

⁹⁰ Marie Eve-Lachance, Ning tang, 'Financial Advice and Trust' (2012) 21 Financial Services Review, 209-226; also see Veerle Colaert, Thomas Incalza, 'Conflicts of Interest and Inducements in the Financial Sector' in Veerle Colaert, Danny Busch, Thomas Incalza (eds.), *European Financial Regulation: Levelling the Cross-Sectoral Playing Field* (2020) Hart Publishing, 377 – 394; see Vanguard's *European Manifesto: Three Steps to Improve the Financial Standing of people in the EU* (February 2020).

⁹¹ Karel Lanoo, Pedro Cunquegrana, 'Capital Markets Regulation Revisited' in Larry Harris, *Regulated Exchanges: Dynamic Agents of Economic Growth* (2010) Oxford University Press, 109-146, 125.

⁹² Michael Haliassos, Alexander Michaelides, 'Asset and Debt Participation of Households: Opportunities and Challenges in Eliminating Borders' in Ester Faia, Franklin Allen, Michael Haliassos and Katja Langenbucher (eds.), *Capital Markets Union and Beyond* (2019) MIT Press, 113 – 126, 118.

⁹³ R. Inderst, M. Ottaviani, 'Competition Through Commissions and Kickbacks' (2012) 102(2) American Economic Association, pp. 780-809, available at: <https://www.aeaweb.org/articles/pdf/doi/10.1257/aer.102.2.780>.

It is often remarked that conflicted advice “*may be of little value or potentially even damaging to the client’s interests*”⁹⁴ because, as others highlight, inducements lead advisers to “*ignore clients’ actual needs and advertise specific products*”.⁹⁵ A study covering the US retirement savings market from 2015 estimates that conflicted advice may “*cause a 12% loss over returns for 30-year savings*”, which amount to a loss of “*\$17 billion per year*”.⁹⁶ An earlier study conducted on the US market for investment recommendations – comparing investment banks and independent research firms – found that, over a period of 7 years (1996 – 2003), “*the buy recommendations of independent research analysts overperform those of banks’ analysts*” by 0.031% per day, which is the equivalent of 220% over the whole time period.⁹⁷ Losses due to conflicted advice may have several explanations:

- as shown in the quantitative evidence below (*quantitative data*), advisers that receive inducements are more inclined to recommend costlier products;⁹⁸
- “*commission-motivated advisers are more likely to misrepresent material information when making recommendations to clients*”;⁹⁹

A study conducted by the Australian financial supervisory authority¹⁰⁰ on a large population of investment advisers shows that advisers “*that had a conflict of interest over remuneration*” were “*six times more common*” to give “*clearly or probably non-compliant*” advice, but half less likely to offer bad advice “*when suggesting an associated product*”.

Even if conflicted advice were to be clearly disclosed to investors, as is required under EU law, the detrimental effects may persist. Some authors contend that, with or without adequate disclosures in place, “*agents tend to be affected unconsciously, i.e., that they pursue their own interest in perfect good faith*”,¹⁰¹ while others find that “*bias persists even when the underlying conflict has disappeared*”.¹⁰²

⁹⁴ J. Burke, A. A. Hung, J. Clift, S. Garber, J. K. Yoong, ‘Impacts of Conflicts of Interest in the Financial Services Industry’ (02/2015) RAND Working Papers, WR-1076, p. 4.

⁹⁵ C. Zhuoqiong, T. Gesche, ‘Persistent Bias in Advice-Giving’ (October 2017) University of Zurich Working Paper no. 28, p. 1.

⁹⁶ CEA, *The Effects of Conflicted Investment Advice on Retirement Savings* (2015) Executive Office of the President of the United States, p. 3, available at: https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf; much more evidence from experiments and surveys is given in the literature review available on page 13.

⁹⁷ We obtained the figure by powering 1.00031 to 365×7 ; it is true that the same study finds, on the contrary, that independent analysts’ *sell* recommendations underperform those of banks’ analysts by 0.018% per day; nevertheless, netting them out, it seems that an investor would be better off with an independent research analyst – see B. M. Barber, R. Leahy, B. Trueman, ‘Comparing the Stock Recommendations’ Performance of Investment Banks and Independent Research Firms’ (2007) 85 *Journal of Financial Economics*, pp. 490–517, available at: <https://www.sciencedirect.com/science/article/abs/pii/S0304405X06000468>.

⁹⁸ Also confirmed by the experiment run by S. Mullainathan, M. Noeth, A. Schoar, ‘The Market for Financial Advice: An Audit Study’ (2012) National Bureau of Economic Research, Working Paper 17929, available at: <http://www.nber.org/papers/w17929>, p. 3.

⁹⁹ Tarun Patel, *Do Commissions Cause Investment Adviser Misconduct?*, Dissertation submitted in partial fulfilment of the requirements for the degree of Doctor of Philosophy University of Washington, 2020, available at: <https://www.proquest.com/openview/621a5dcdf188fe429e903d0a50887367/1?pq-origsite=gscholar&cbl=44156>.

¹⁰⁰ Australian Securities and Investments Commission, *Shadow Shopping Survey on Superannuation Advice* (April 2006) Report 69, available at: https://download.asic.gov.au/media/1347026/shadow_shop_report_2006.pdf, p. 8.

¹⁰¹ L. Enriques, ‘Conflicts of Interests in Investment Services: The Price and Uncertain Impact of Mifid’s Regulatory Framework’ (2005) University of Bologna & ECGI, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=782828.

¹⁰² This means that distributors continue to be influenced and advise on risky or unsuitable products (that they used to advise) – see C. Zhuoqiong, T. Gesche, ‘Persistent Bias in Advice-Giving’ (October 2017) University of Zurich Working Paper no. 28, p. 1.

STATISTICAL DATA

I. Statistics on capital flows of EU26 and NL households

In the public debate on retail financial services, the financial balance sheets¹⁰³ of EU households are often used as a benchmark to measure progress on certain policy actions, e.g., increasing retail investments in equities and bonds.¹⁰⁴ For instance, one could compare the value of life insurance holdings of Dutch households' before and after the inducements ban to determine whether advisers changed investment recommendations thanks to the absence of economic incentives.

BETTER FINANCE research team analysed the *cash flows* into different financial assets. Put simply, we looked at what assets households **invested in** or **divested from** over a certain period. If the net cash flow (in plus out) is negative, it means households divested, and if the net cash flow is positive, it means households invested. The data is available on a quarterly basis, starting with the first quarter of 2012 and ending with the last quarter of 2019.¹⁰⁵

These computations return the absolute values of transactions (in € or local currency) which cannot be compared between jurisdictions because of the differences between local markets in terms of size and currencies. Therefore, the research team computed the relative value of cashflows on certain assets as a percentage of the total value of transactions.

Example: Dutch savers divested an overall €14.5 bln from debt securities between 2012 and 2019 and allocated €72.17 bln to currency and deposits. From the total net value of €228.15 bln in transactions, Dutch households divested 6.4% from debt securities and invested 31.6% in currency and deposits.

Table 1 shows, in decreasing order by size and asset type (currency & deposits, C&D; debt securities, DS; listed equities, LE; investment funds, IFs; life insurances, LIs; pensions, Pens) the relative value of transactions of households in each jurisdiction. The purpose of the table is to show the differences across EU27 jurisdictions and the Netherlands and see where most of the capital has been directed to.

¹⁰³ The “financial balance sheet” is an accounting term describing the investment portfolio; therefore, the financial balance sheets of EU households refers to the aggregate financial holdings of EU citizens at the end of a certain period – for more information on EU accounting and statistical terms, see Eurostat, *European System of Accounts, 2010*, Chapter 7, p. 168-169, available at: <https://ec.europa.eu/eurostat/documents/3859598/5925693/KS-02-13-269-EN.PDF/44cd9d01-bc64-40e5-bd40-d17df0c69334>.

¹⁰⁴ In this sense, please refer to the European Commission document on the toolkit of indicators to monitor progress towards the Capital Markets Union - European Commission, *Commission Staff Working Document: Monitoring Progress Towards a Capital Markets Union – A Toolkit of Indicators*, (09.06.2021) SWD(2021) 544 final, available at: https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/210609-capital-markets-union-indicators_en.pdf.

¹⁰⁵ The period covering 2020 was excluded for two reasons: first, the data is not available for all 27 jurisdictions for 2020; second, retail investors exhibited a very different behaviour during the COVID lockdowns, which in our view was not influenced by advisers – see Annex 2 of BETTER FINANCE's Response to the EU Commission's Public Consultation on the EU Strategy for Retail Investors (3 August 2021), available at: <https://betterfinance.eu/wp-content/uploads/BETTER-FINANCE-Response-EC-Strategy-for-Retail-Investors-03082021-Annex-2.pdf>.

Table 3. EU27 households' cashflows (as a % of total) by asset type

Country	C&D	Country	DS	Country	LE	Country	IFs	Country	LIs	Country	Pens
PT	161%	CY	47%	MT	4%	ES	153%	IT	70%	NL	80%
LT	105%	HU	41%	DE	4%	IT	95%	DK*	62%	SE	46%
BE	104%	SK	5%	LU	4%	CY	42%	FR	37%	EE	31%
IT	101%	RO	4%	LV	4%	DK*	34%	ES	30%	IE*	31%
GR	98%	GR	3%	GR	3%	BE	33%	FI	25%	LT	26%
PL	85%	CZ	2%	EE	3%	PT	32%	DE	16%	RO	25%
ES	77%	IE*	2%	LT	2%	FI	24%	LU	14%	HR	22%
SI	72%	MT	1%	AT	1%	AT	23%	LV	14%	BE	21%
DK*	68%	PL	1%	SK	1%	EU26	20%	EU26	11%	ES	15%
AT	67%	EE	1%	CZ	1%	CZ	14%	IE*	8%	DE	15%
FI	66%	HR	0%	RO	1%	DE	11%	LT	6%	BG	15%
LU	63%	BG	0%	HU	0%	SE	9%	MT	6%	SK	15%
LV	63%	SI	-1%	PL	0%	LU	9%	HR	5%	IT	14%
CZ	59%	SE	-3%	BG	-1%	LV	9%	SI	3%	AT	13%
SK	59%	FR	-4%	SE	-1%	SK	9%	SK	3%	CZ	13%
EU26	57%	LU	-5%	NL	-1.6%	PL	8%	EE	3%	EU26	13%
IE*	57%	LV	-5%	FR	-2%	HR	8%	RO	2%	SI	7%
RO	54%	DE	-6%	FI	-2%	HU	7%	BG	1%	HU	3%
MT	54%	NL	-6.4%	EU26	-2.1%	MT	4%	HU	1%	LU	2%
DE	52%	FI	-7%	IE*	-2%	SI	4%	SE	1%	LV	2%
EE	52%	LT	-10%	BE	-3%	LT	4%	CZ	0%	DK*	1%
FR	47%	EU26	-14%	HR	-3%	RO	4%	PL	0%	PT	1%
HR	41%	DK*	-17%	SI	-3%	NL	2.1%	AT	-1%	FI	-1%
BG	34%	AT	-18%	PT	-8%	BG	1%	GR	-2%	GR	-1%
NL	32%	PT	-41%	DK*	-10%	IE*	1%	BE	-3%	CY	-7%
HU	32%	BE	-53%	IT	-11%	EE	1%	NL	-5.3%	PL	-8%
SE	25%	ES	-134%	CY	-15%	GR	-4%	CY	-10%	FR	
CY	-209%	IT	-173%	ES	-23%	FR	-6%	PT	-12%	MT	

Source: BETTER FINANCE own composition based on ECB SDW data

In order to get a clearer picture of how Dutch households compare with the rest of jurisdictions and with the EU26 average, the table above can be transformed into a graph showing percentiles.

A percentile shows how many values in a list are higher or lower than a certain value. For instance, Dutch households directed 32% of their financial transactions between 2012-2019 to currency & deposit transactions, which is the fourth smallest value in the list. As such, NL households represent the 14th percentile. In other words, 86% of all other values are higher than that of NL households – same goes for all other columns.

The table above shows how Dutch households compare with other jurisdictions and the EU26 average:

- they are among the jurisdictions to have invested the least in:
 - currency & deposits, well below the EU26 average (57%) and five times less than the maximum observed (Portugal, 161%);
 - investment fund units, ten times less than the EU26 average and 72 times less than the maximum observed (Spain, 153%);
- they invested the highest amount of all jurisdictions in pension products (80%), whereas the EU26 average stands at 13%;
- they were among the very few to divest from life insurance products, whereas 78% of all other jurisdictions invested in life insurances;
- they were among those jurisdictions among the EU26 to divest the least from listed equities;
- they divested significantly, but still above the EU26 average, from debt securities.

In short, this data stands to show that Dutch households have been far more oriented to pension savings and direct investments (equities and debt securities) compared to the other EU Member States and well above the EU26 average.¹⁰⁶

In 2017 the European Insurance and Occupational Pensions Authority (EIOPA) undertook a thematic review of inducements in the EU insurance market,¹⁰⁷ surveying 218 insurance undertakings representing 70% of the unit-linked insurance market by AuM at the end of 2014. The study, aimed at gathering evidence on the “*interlinkages between [asset managers and insurers], and potential impacts for consumers*”,¹⁰⁸ found that 81% of the participating insurance undertakings¹⁰⁹ (thus, **at least 57%** of the insurance market) received inducements from asset managers providing the underlying investments (funds) for unit-linked contracts.

To begin with, it should be noted that 68% of the assets held in unit-linked contracts are managed by in-house asset managers, i.e., investment firms that are part of the same group as the insurance undertaking.¹¹⁰ Given that 53% of all inducements received by insurers come from in-house managers,¹¹¹ it immediately raises the question of whether these arrangements do not *per se* represent a conflict of interest.

Second, EIOPA estimated that, in 2015, the total value of inducements paid by asset managers to insurers amounted to €5.2 billion, an increase of 21.7% compared to the preceding year.¹¹² The median value of inducements paid, calculated as a percentage of the assets under management, was 0.56% and 0.46% relative to the fund management charges.¹¹³ As highlighted below as well, the data reported by EIOPA shows that inducements almost double the ongoing costs of funds.

Moreover, EIOPA found that the riskier the funds (as underlying options), the higher the level of inducements, which suggests that inducements favour riskier products – as identified by specialised literature (above). In 2015, the average inducement (as % of assets under management) for equity funds was more than double the that for bond and money market funds (0.54% vs 0.24% and 0.2%).¹¹⁴ The same holds at a more general level, since actively managed funds respectively paid more monetary incentives than passively managed ones (0.44% vs 0.32%).¹¹⁵

The issue becomes more sensitive as:

- 99.1% of all inducements paid are recurring ones (as trailing commissions or discounts on fund management charges), which means that policyholders pay for the one-off distribution service every year, as long as they do not redeem the policy;¹¹⁶

¹⁰⁶ Methodological notes: For Denmark and Ireland, the cashflow data is missing for the first three quarters of 2012; For France and Malta, the cashflow data for pensions is entirely unavailable for the whole reporting period;

¹⁰⁷ European Insurance and Occupational Pensions Authority, Report on Thematic Review on Monetary Incentives and Remunerations Between Providers of Asset Management Services and Insurance Undertakings (26 April 2017) EIOPA-BoS-17-064, available at: <file:///C:/Users/Stefan/AppData/Local/Temp/Report%20on%20thematic%20review%20on%20monetary%20incentives%20and%20remuneration%20-%20EN.pdf>, hereinafter “EIOPA report on inducements”.

¹⁰⁸ EIOPA report on inducements (n 45), p. 7.

¹⁰⁹ EIOPA report on inducements (n 45), p. 23.

¹¹⁰ EIOPA report on inducements (n 45), p. 44.

¹¹¹ EIOPA report on inducements (n 45), p. 30.

¹¹² EIOPA report on inducements (n 45), p. 22.

¹¹³ EIOPA report on inducements (n 45), p. 34.

¹¹⁴ EIOPA report on inducements (n 45), p. 39-40.

¹¹⁵ *Ibid.*

¹¹⁶ EIOPA report on inducements (n 45), p. 33.

- 69% of the surveyed insurance undertakings “**do not disclose** monetary incentives and remunerations received to policyholders”.¹¹⁷

As highlighted by EIOPA, “if the value of [inducements] could be fully captured by policyholders in higher net returns”, this would bring considerable benefits for investors, particularly considering that many insurance-based investment products are used for long-term¹¹⁸ and retirement saving purposes.¹¹⁹

II. Evidence from the French unit-linked market

Research from the French unit-linked market reveals many detrimental effects stemming from inducements. A study on fees and performances of unit-linked contracts - distinguishing between classic contracts, clean share classes (no inducements paid) and ETFs - shows a very grim picture for individual, non-professional investors. To begin with, the value of retail investment funds held via life insurance contracts in France was €413 million at the end of 2020, compared to €255 held in securities accounts, according to data from the French Central Bank. Second, more than 60% of unit-linked insurance contracts are distributed through banking networks (*bancassurance*).

Analysing the breakdown by nature of funds distributed and by type of distribution channel, the report on the French unit-linked market shows that 99% of classic funds are distributed through bancassurance networks, and only a very small margin of 0.4% and 0.6% are clean share classes (no commissions) or ETFs. While online platforms sell far more ETFs (6.6%), tied agents (insurance intermediaries that receive commissions) do not distribute ETFs at all and only 0.9% of the funds are clean share classes. This data stands in stark contrast to the US market, where the share of ETF holdings is equal between retail and institutional share classes.

Table 4. French UL insurance - breakdown by nature			
Distributor	Bancassurance	Agents	Internet
Classic	99.0%	99.1%	92.5%
Clean share class	0.4%	0.9%	0.9%
ETF	0.6%	0.0%	6.6%
Total	100%	100%	100%
Av. commissions on funds	0.77%	0.75%	0.74%

Source: GoodValueForMoney.eu

BETTER FINANCE estimates that - based on this current level of commissions (0.75% per year) in France, personal pension (“PER”) savers will have to pay an extra €25 billion in commissions to distributors and providers over 20 years (up to 2019 these commissions had to be credited to the pension plans “PERP”).

Table 5. French UL insurance - Performance and charges			
	5Y annual av. return*	funds' ongoing costs	total ongoing cost*
French equities	2016-2020		
Classic	4.07%	1.98%	2.88%
Clean share classes	5.52%	1.14%	2.04%
ETFs	6.06%	0.52%	1.42%

¹¹⁷ EIOPA report on inducements (n 45), p. 44.

¹¹⁸ EIOPA report on inducements (n 45), p. 43.

¹¹⁹ See BETTER FINANCE’s annual report on the *Real Returns of Long-term and Pension Saving Products* (2021 edition), BETTER FINANCE, available at: <https://betterfinance.eu/publication/real-return-of-long-term-and-pension-savings-report-2021-edition/>.

Mixed "moderate"		2016-2020	
Classic	1.89%	1.96%	2.86%
UL clean shares	3.60%	0.91%	1.81%
European bonds		2016-2020	
Classic	0.86%	0.96%	1.86%
UL clean shares	1.27%	0.50%	1.40%
ETFs	1.52%	0.17%	1.07%

*excluding additional charges if under delegated management

Source: GoodValueForMoney.eu

Looking at the cost and performance of unit-linked insurances in the French market, we observe that classic contracts (as described above) have lower net returns over the 5-year period (2016-2020) and higher costs, both for the underlying funds and total costs. Based on ESMA's annual statistical report on cost and performance of retail investment products (2021), the average cost of equity UCITS is 1.5%, but the majority of French retail stock fund investors actually pay nearly the double. Unfortunately, the pre-contractual disclosure document (PRIIPs KID) does not give the full cost per unit (even projected as a "RiY" in one future scenario for specific holding periods), and it is not taken into account in AMF and ESMA statistics on investor costs and returns either.

French stock ETF charges in unit-linked contracts are more than double the market average: there are not only index ETFs (less than 0.25% average charge) but also other much higher cost index funds in this statistical data.

Third, in most cases, inducements double the fixed costs paid by subscribers in most types of distribution channels, weighing between 46% and 63% of the total fixed costs. In turn, this triggers a significant impact, even in the short-term, for nominal net returns. The table below calculates the difference in the average fixed costs and ongoing charges between classic unit-linked contracts and the two other, inducements-free, contracts: clean share classes and ETFs.

Clean share classes are between 40 bps (0.40%) and 89 bps (0.89%) cheaper in terms of fixed costs and between 46 bps (0.46%) and 105 bps (1.05%) in terms of ongoing charges compared to classic unit-linked contracts.

III. Evidence on payments for order flow (PFOF)

Payments for order flow (PFOF) are a specific type of inducements paid by execution venues (for trades in financial instruments) to brokers for directing clients' orders (buy/sell) to them, generally a revenue stream for zero commission brokers. Among its shortcomings, PFOF creates for the retail client the illusion of "free trading" as it hides execution costs and fees charged,¹²⁰ it can create a conflict of interests around best execution, it involves higher overall costs for retail investors, leads to competition and overall price deterioration and potentially to lower quality for all investors.¹²¹

The earliest evidence we could find on payments for order flow comes from a speech delivered by Commissioner Roberts of the US Securities and Exchange Commission (SEC) in 1993

¹²⁰ Samuel Adams, Connor Kasten, Eric K. Kelley, *Do investors save when market makers pay? Retail execution costs under payment for order flow models*. (December 1, 2021), available at: <https://dx.doi.org/10.2139/ssrn.3975667>.

¹²¹ Christine A. Parlour, Uday Rajan, 'Payment for order flow' (2003) *Journal of Financial Economics* 68(3), 379-411. Available at: <https://www.sciencedirect.com/science/article/abs/pii/S0304405X03000710>; Robert H. Battalio, Tim Loughran, 'Does payment for order flow to your broker help or hurt you?' (2008) *Journal of Business Ethics* 80, 37-44, available at: <https://link.springer.com/article/10.1007%2Fs10551-007-9445-x>.

addressing the practice, without taking a side, but highlighting the few opinions expressed at the time:

- the general investor audience was unaware of the practice, but deemed it “unsavoury”;
- some questioned whether it does comply with “*just and equitable principles of trade*”;
- other raised concerns about it being “*akin to commercial bribery*”.

It seems that the practice first caught the attention of US regulators in “late 1984”, and it already raised several issues concerning:

- brokers’ fiduciary duty towards clients;
- price discovery mechanisms;
- competition among market makers; and
- may disincentivise quoting narrower spreads.¹²²

Throughout the years, the issue of payments for order flow (PFOF) sporadically caught the attention of regulators, stakeholders, and investors in general. The latest event to focus attention on the practice was the *GameStop*¹²³ case of January 2021, when questions were asked about an investment firm paying a broker for routing retail clients’ trade orders.

However, it was not the first instance for authorities to issue sanctions on PFOF; the same broker was sanctioned before:

- by FINRA, in November 2019, \$1.25 million (€1.1 million) for:
 - failing to “*reasonably consider (...) execution quality factors*”,
 - not performing “*systematic best execution reviews*” and
 - not having a supervisory system “*reasonably designed to achieve compliance with its best execution obligations*”,¹²⁴
and
- by the US SEC a month before the *GameStop* case, in December 2020, when it was given a fine for a total of \$65 million (€52.7 million) for “*misleading customers about revenue sources and failing to satisfy duty of best execution*”.¹²⁵

The 2019 fine by FINRA, the self-regulatory body of the financial industry in the US, was ordered in light of the continuous breach of the best execution duty for a period of over a year, spanning between October 2016 and November 2017. According to FINRA, the platform failed to consider alternative markets that could have offered price improvements on the orders of its clients.

The SEC also started investigations in 2020 and found, first, that the brokerage firm “*misleadingly omitted payment for order flow from descriptions of its revenue sources*”. In simpler

¹²² The quotes and information come from Commissioner Richard Y. Roberts of the US Securities and Exchange Commission, Remarks on “Payment for Order Flow” delivered on 23 April 1993 at “The 1993 Ray Garret Jr Corporate and Securities Law Institute”, Chicago, Illinois, available at: <https://www.sec.gov/news/speech/1993/042993roberts.pdf>.

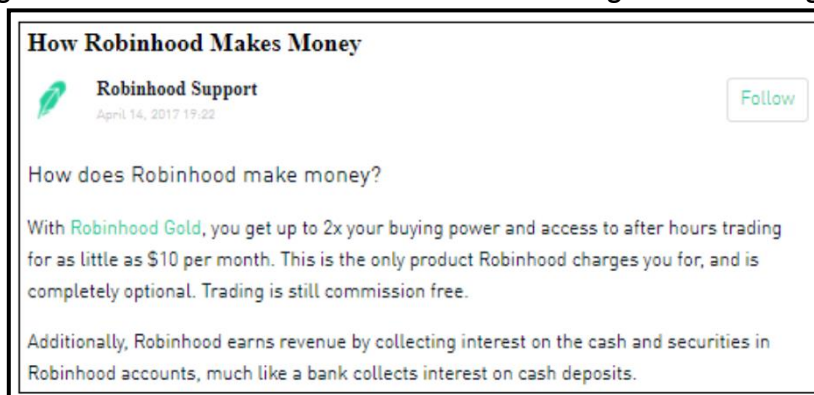
¹²³ See BETTER FINANCE Press Release, *GameStop Case Highlights Discrimination of “Retail” Investors in Stock Markets* (4 March 2021), available at: <https://betterfinance.eu/wp-content/uploads/PR-GameStop-highlights-Discrimination-of-Non-professional-Investors-in-Stock-Markets-04032021.pdf>.

¹²⁴ Financial Industry Regulatory Authority, ‘FINRA Fines Robinhood Financial, LLC \$1.25 Million for Best Execution Violations’ (19 December 2019), FINRA News Release, accessed 2 October 2021, available at: <https://www.finra.org/media-center/newsreleases/2019/finra-fines-robinhood-financial-llc-125-million-best-execution>.

¹²⁵ US Securities and Exchange Commission, Press Release: SEC Charges Robinhood Financial With Misleading Customers About Revenue Sources and Failing to Satisfy Duty of Best Execution, 2020-321, available at: <https://www.sec.gov/news/press-release/2020-321>.

terms, the brokerage firm informed clients that it made money from “*interest collected on cash and securities held in Robinhood accounts, much like a bank collects interests on cash deposits*”,¹²⁶ and not from payments for order flow (PFOF), which we later learned had generated \$221.4 million (€179.3 million) in revenues in 2020 and already \$547.8 million (€443.7 million) in the first half of 2021.¹²⁷

Image 7. Screenshot from the Robinhood website during the SEC investigation



Source: page 8 of US SEC Order in Administrative No. 3 -20171

Second, the SEC also found that the broker’s “*customers received inferior execution prices compared to what they would have received from Robinhood’s competitors*”, which is a breach of the best execution duty.¹²⁸ In total, the damage to customers evaluated by the SEC order amounted to \$34.1 million (€27.6 million) “*even after taking into account savings from not paying commissions*”.¹²⁹

Eventually, Robinhood was again fined “*record financial penalties*” also by FINRA totalling \$57 million and ordered to pay compensation to customers worth \$12.6 million for “*significant harm suffered by customers*”.¹³⁰

However, Robinhood is not the only broker to be sanctioned for breaching best execution requirements due to payments for order flow. The Violation Tracker¹³¹ shows 12 records of penalties incurred by E*Trade, a subsidiary of Morgan Stanley Inc, for breaches of investor protection rights. For instance, in 2016, FINRA sanctioned E*Trade for \$900,000 for “*best execution and protection of customer order information*”.¹³²

¹²⁶ United States Securities and Exchange Commission Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Administrative Proceedings, File No. 3-20171, in the matter of Robinhood Financial, LLC, as a respondent, available at: <https://www.sec.gov/litigation/admin/2020/33-10906.pdf>.

¹²⁷ Source: <https://daytradingz.com/payment-for-order-flow/>.

¹²⁸ United States Securities and Exchange Commission Order (no 3), available at: <https://www.sec.gov/litigation/admin/2020/33-10906.pdf>.

¹²⁹ US Securities and Exchange Commission, Press Release: SEC Charges Robinhood Financial With Misleading Customers About Revenue Sources and Failing to Satisfy Duty of Best Execution, 2020-321, available at: <https://www.sec.gov/news/press-release/2020-321>.

¹³⁰ Financial Industry Regulatory Authority, ‘FINRA Orders Record Financial Penalties Against Robinhood Financial LLC’ (31 June 2021), FINRA News Release, accessed 2 October 2021, available at: <https://www.finra.org/media-center/newsreleases/2021/finra-orders-record-financial-penalties-against-robinhood-financial>.

¹³¹ Platform set up by Good Jobs First comprising all individual penalty records of companies in the US, see <https://www.goodjobsfirst.org/>.

¹³² Good Jobs First, Violation Tracker Individual Record for E-Trade Securities LLC, available at: <https://violationtracker.goodjobsfirst.org/violation-tracker/e-trade-securities-llc-0>, sourced from Financial Industry Regulatory Authority, ‘FINRA Fines E*Trade Securities LLC \$900,000 for Supervisory Violations Related to Best Execution and Protection of Customer Order Information’ (2 June 2016) accessed 2 October 2021, available at: <https://www.finra.org/media-center/news-releases/2016/finra-fines-etrade-900k-best-execution-and-protection-customer-order>.

In the UK, the views of the UK Financial Conduct Authority (FCA) on the topic were clear since 2012,¹³³ when it held that, while not being prohibited, PFOF *“is unlikely to be compatible with our inducements rule and risks compromising compliance with best execution rules”*. The guidance provided by the UK FCA to firms highlighted that PFOF must satisfy five tests required by law:

- inducements rule, i.e.:
 - must not impair with the duty to act in the best interests of the client;
 - must be disclosed ex-ante *“in a manner that is comprehensive, accurate and understandable”*; and
 - must enhance the quality of the service;
- best execution rule, i.e., to take all reasonable steps to ensure the best possible result (represented by the price obtained and costs paid), taking into consideration factors such as speed, likelihood of execution and settlement etc.;
- and
- conflicts of interest rule, i.e. prevent, manage, and adequately disclose them.

During a thematic review looking into best execution and PFOF, the FCA found that “a small number of firms” continued to use this practice in contravention of their position; however, it showed that *“firms do not understand key elements of our requirements and not embedding them into their business practice”*.¹³⁴ In a Dear CEO letter of December 2017, the UK FCA made a couple of statements that firmly condemn the practice of PFOF:

- *“firms that continue to charge payments for order flow will breach the new standards implemented in MiFID II”*;
- PFOF is likely *“to cause harm to clients and markets”*; or
- PFOF *“substantially undermines a broker’s ability to act as a good agent”*.¹³⁵

The European Securities and Markets Authority (ESMA) also stepped in and sent a strong message on PFOF and client disclosures in 2021. ESMA issued a supervisory statement analysing PFOF from the point of view of inducements and conflicts of interests, highlighting that:

- *“PFOF raises serious investor protection concerns”*
 - *“in most cases it is unlikely that PFOF could be compatible with MiFID II and its delegated acts”*
- and urged national supervisors to step up efforts in investigating this practice:
- *“ESMA requests NCAs to prioritise PFOF in their supervisory activities for 2021 or early 2022, especially in those Member States in which PFOF has been observed”*.¹³⁶

Existing data on payment for order flow raises serious concerns about whether such a practice can be in the best interest¹³⁷ of the client and satisfy the *best execution* duty.¹³⁸ Even more so than for inducements in investment advice, the question of where the advisor’s remuneration comes from, if not from clients, is more pressing than ever.

¹³³ Financial Services Authority, *Finalised Guidance: Guidance on the Practice of “Payment for Order Flow”* (May 2012), available at: <https://www.fca.org.uk/publication/finalised-guidance/fg12-13.pdf>

¹³⁴ United Kingdom Financial Conduct Authority, *Best Execution and Payment for Order Flow* (14 July 2014) Thematic Review 13/14, available at: <https://www.fca.org.uk/publication/thematic-reviews/tr14-13.pdf>.

¹³⁵ United Kingdom Financial Conduct Authority, *Dear CEO: Payment for Order Flow (PFOF)*, 13 December 2017, available at: <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-payment-for-order-flow.pdf>.

¹³⁶ European Securities and Markets Authority, *Public Statement: ESMA Warns Firms and Investors About Risks Arising from Payment for Order Flow and from Certain Practices by “Zero-Commission” Brokers* (13 July 2021) ESMA35-43-2749, available at: https://www.esma.europa.eu/sites/default/files/library/esma35-43-2749_esma_public_statement_pfof_and_zero-commission_brokers.pdf.

¹³⁷ According to Art. 24(1) of MiFID II, any investment professional must act in the best interests of its client.

¹³⁸ Brokers are obliged (Art. 27 MiFID II) to endeavour to *“execute orders on terms most favourable to the client”* and *“obtain the best possible result”* for their clients.

If, with conflicted advice, it is the client that ultimately bears the inducements paid to the advisor (through the management fees charged by the product manufacturer), with execution of orders there is no such relationship: the investor does not pay the market maker any fee. So, where does the market maker generate the necessary cashflow to remunerate the broker for directing orders to him and why does the market maker need to pay for order flow routing if it has competitive execution conditions?¹³⁹

A simple answer would be from the price difference obtained when executing the order (buy/sell). Yet, this implies that the price difference must be sufficient in order to cover operational costs, cover the broker's inducement, and generate some profit. When looking at data from the US market, we observe that the seven biggest brokerages that accept PFOF earned \$2.6 billion (€2.1 billion) from this practice in 2020 and another \$1.8 billion (€1.5 billion) only in the first half of 2021.

Table 6. Top 10 PFOFs received by brokers in the US

Payment for Order Flow	year	Quarter_Q							
	2020	2020	2020	2020	2020 Total	2021	2021	2021 Total	
Brokerage	Q1	Q2	Q3	Q4		Q1	Q2		
TD Ameritrade	\$ 202,176,174	\$ 324,211,345	\$ 297,902,649	\$ 324,260,334	\$ 1,148,550,502	\$ 428,923,484	\$ 329,563,835	\$ 758,487,319	
Robinhood	\$ 90,921,176	\$ 180,264,396	\$ 194,550,463	\$ 221,358,956	\$ 687,094,992	\$ 330,862,253	\$ 216,957,485	\$ 547,819,737	
E*Trade	\$ 79,651,749	\$ 110,327,376	\$ 105,425,567	\$ 107,089,267	\$ 402,493,959	\$ 139,403,087	\$ 103,619,245	\$ 243,022,332	
Charles Schwab	\$ 53,577,203	\$ 66,142,015	\$ 61,868,774	\$ 63,875,993	\$ 245,463,984	\$ 78,081,154	\$ 61,243,649	\$ 139,324,803	
Webull	\$ 3,093,917	\$ 10,705,128	\$ 21,918,111	\$ 28,136,747	\$ 63,853,903	\$ 46,021,618	\$ 46,369,010	\$ 92,390,628	
TradeStation	\$ 6,250,020	\$ 10,030,145	\$ 12,182,576	\$ 13,382,114	\$ 41,844,854	\$ 17,143,896	\$ 13,470,979	\$ 30,614,875	
Ally Invest	\$ 3,178,083	\$ 4,484,013	\$ 3,792,074	\$ 3,815,883	\$ 15,270,053	\$ 4,561,965	\$ 3,247,113	\$ 7,809,078	
Grand Total	\$ 438,848,322	\$ 706,164,417	\$ 697,640,215	\$ 761,919,294	\$ 2,604,572,249	\$ 1,044,997,457	\$ 774,471,315	\$ 1,819,468,772	

Source: <https://daytradingz.com/payment-for-order-flow/>

Table 7. Top 10 PFOF providers in the US

Payment for Order Flow	year	Quarter_Q							
	2020	2020	2020	2020	2020 Total	2021	2021	2021 Total	
Venue	Q1	Q2	Q3	Q4		Q1	Q2		
Citadel	\$ 164,207,937	\$ 285,034,232	\$ 293,979,316	\$ 340,906,851	\$ 1,084,128,336	\$ 450,910,427	\$ 309,948,638	\$ 760,859,065	
Global Execution Brokers	\$ 53,223,175	\$ 119,633,670	\$ 132,587,614	\$ 140,549,199	\$ 445,993,659	\$ 182,069,190	\$ 151,769,336	\$ 333,838,525	
Virtu Americas	\$ 53,022,423	\$ 91,600,016	\$ 88,488,780	\$ 78,443,303	\$ 311,554,521	\$ 117,488,878	\$ 72,613,607	\$ 190,102,485	
Wolverine	\$ 36,987,302	\$ 45,332,765	\$ 51,784,294	\$ 47,170,348	\$ 181,274,709	\$ 88,754,047	\$ 95,069,086	\$ 183,823,133	
other	\$ 47,351,443	\$ 57,954,305	\$ 28,249,423	\$ 28,655,130	\$ 162,210,301	\$ 44,221,805	\$ 37,161,811	\$ 81,383,616	
Two Sigma Securities	\$ 6,771,950	\$ 16,144,904	\$ 14,623,228	\$ 25,768,570	\$ 63,308,651	\$ 48,237,773	\$ 30,343,341	\$ 78,581,114	
G1 Execution Services	\$ 51,414,705	\$ 50,778,470	\$ 42,765,085	\$ 49,920,601	\$ 194,878,861	\$ 43,806,916	\$ 31,433,117	\$ 75,240,033	
Dash Financial Technologies	\$ 17,616,719	\$ 20,500,168	\$ 31,260,986	\$ 36,052,822	\$ 105,430,694	\$ 41,336,413	\$ 27,690,621	\$ 69,027,034	
UBS Securities	\$ 8,252,669	\$ 19,185,887	\$ 13,901,489	\$ 14,452,470	\$ 55,792,516	\$ 28,172,008	\$ 18,441,758	\$ 46,613,767	
Grand Total	\$ 438,848,322	\$ 706,164,417	\$ 697,640,215	\$ 761,919,294	\$ 2,604,572,249	\$ 1,044,997,457	\$ 774,471,315	\$ 1,819,468,772	

Source: <https://daytradingz.com/payment-for-order-flow/>

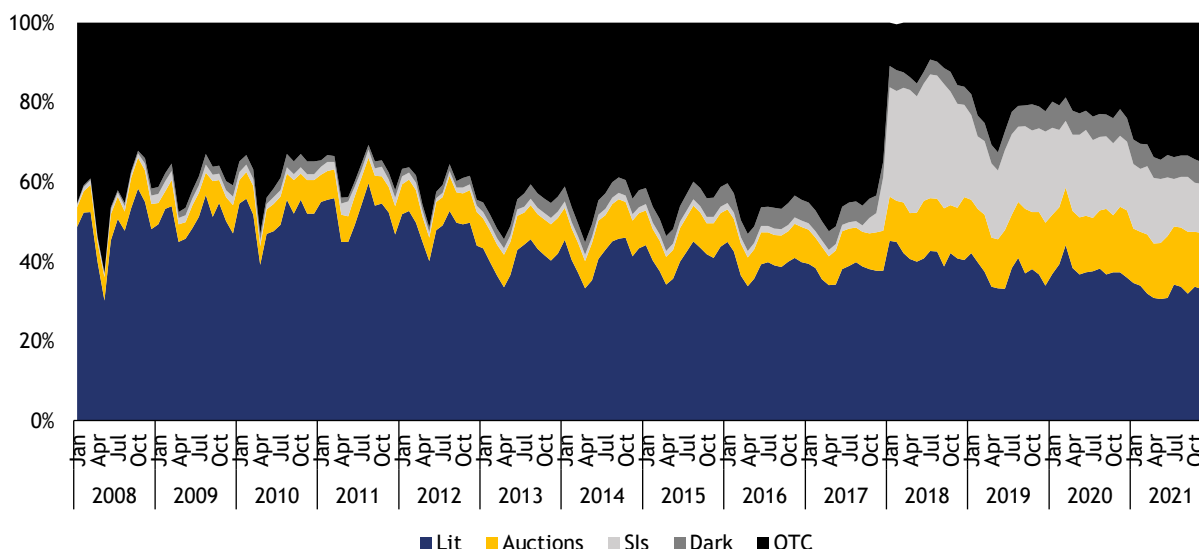
This means that, in the US only, and only in relation to the orders directed by the seven largest brokerage firms, some \$4.4 billion (€3.6 billion) were earned by execution venues in excess of the cash covering operational costs and the profit margin (return on investment) from dealing against individual investors.

Payment for order flows can also affect the price formation processes: typically, market makers who pay for directing orders trade in their own name, i.e. buy or sell a security themselves instead of intermediating or hosting an order matching mechanism. In such cases, there is no transparency obligation. Thus, by capturing large flows of trades, market makers may deprive primary markets of liquidity and depth in the limit order books, which ultimately affects price formation. In the end, only informed orders will arrive on transparent venues, which can

¹³⁹ See also Financial Services Authority, *Finalised Guidance: Guidance on the Practice of "Payment for Order Flow"* (May 2012), available at: <https://www.fca.org.uk/publication/finalised-guidance/fg12-13.pdf>, where it analyses the disadvantages of PFOF and highlights that the "obvious concern, however, is that the market maker offers this payment to attract orders that would not otherwise be obtained (i.e. by virtue only of the price offered by the market maker)" – p. 2, paras 11-13.

increase price differences (spreads). In 2020, according to ESMA, 80% of the trades executed on systematic internalisers were below the standard market size (SMS), with an average value of €3,000. Thus, we can assume that these trades are from retail investors, given their generally limited size, and this may be happening precisely because systematic internalisers may be paying for order flows.

Chart 8. European equity turnover by venue type



Source: CFA Institute, Gomber et al., Oxera, and Big xyt

III. Studies on fees & expenses: much lower in countries with no inducements

Inducements primarily affect investors because they increase the cost of investing, i.e., management fees. Given that all commissions, kickbacks, rebates, etc., paid to intermediaries must be recouped by product manufacturers, it's usually clients that pick up the bill in the end.

A 2019 [paper](#)¹⁴⁰ on the level and structure charges in relation to the distribution and management of investment funds provides clear evidence on how often, and how large, inducements are in those markets where these are allowed. The report distinguishes between *equity*, *fixed income*, and *allocation* funds in a selection of jurisdictions (BE, DL, FI, FR, DE, IT, NL, ES, SE, and the UK) and analyses the median cost for investment funds and their ranges.

Table 9. Morningstar Global Investor Experience Study on Fees and Expenses

	EQUITY funds		FIXED INCOME funds		ALLOCATION funds	
	Median	Range	Median	Range	Median	Range
BE	1.82%	<1.75% - 2%	1.28%	<1.15% - 1.30%	1.67%	<1.65% - 1.80%
DK	1.81%	<1.75% - 2%	1.07%	<1% - 1.15%	1.54%	<1.50% - 1.65%
FI	1.80%	<1.75% - 2%	1.22%	<1.15% - 1.30%	1.54%	<1.50% - 1.65%
FR	1.75%	<1.5% - 1.75%	1.05%	>1.30%	1.60%	<1.50% - 1.65%
DE	1.72%	<1.5% - 1.75%	1.03%	<1% - 1.15%	1.49%	<1.65% - 1.80%
IT	1.83%	<1.75% - 2%	1.25%	<1.15% - 1.30%	1.71%	<1.65% - 1.80%
NL	0.92%	<1%	0.57%	< 0.5%	0.97%	<1%
ES	1.82%	<1.75% - 2%	1.04%	<1% - 1.15%	1.64%	<1.50% - 1.65%

¹⁴⁰ Grant Kennaway, Christina West, Wing Chan, Jackie Choy, Jose Garcia Zarate CFA, Jonathan Miller, Germaine Share, Jackie Beard FCSI, *Global Investor Experience Study: Fees and Expenses* (17 September 2019) Morningstar, available at: https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780.

SE	1.69%	<1.5% - 1.75%	1.04%	<1% - 1.15%	1.54%	<1.50% - 1.65%
CH	1.70%	<1.5% - 1.75%	1.11%	<1% - 1.15%	1.55%	<1.50% - 1.65%
UK	1.57%	<1.5% - 1.75%	1.10%	<1% - 1.15%	1.47%	<1.25% - 1.50%
US	0.59%	<1%	0.42%	< 0.5%	0.60%	<1%

Source: Morningstar study

It can be observed from the table above that the cheapest investment funds (median and annual cost range) in Europe are sold in the Netherlands and in the UK, where bans on inducements have been in force since 2012 and 2014 respectively. Only one exception stands out, i.e., fixed income funds sold in the UK, which are among the most expensive out of the 10 European jurisdictions observed. In addition, in some countries like France, the majority of retail funds are subscribed via insurance contracts, bringing the average total charge on equity fund units up to 2.91% instead of the “median” 1.75% found by Morningstar.¹⁴¹

In addition to the quantitative assessment, the paper analyses the structure and characteristics of distribution channels in the selected jurisdictions, focusing on aspects such as performance fees, inducements, availability or access to independent advice or robo-advisors (automated investment platforms) or the availability of exchange-traded funds (ETFs).

Analysed together, the authors’ findings for the 10 European jurisdictions in focus are interesting and reveal (without spelling out) four general conclusions:

- retail investors very rarely pay for advice (i.e., benefit of *independent* advice);
- there are very few independent advisors in these jurisdictions;
- retail investors have very little access to low-cost ETFs or clean share classes;
- the fund distribution market is dominated by banks in several jurisdictions, which have very few incentives to sell low-cost ETFs or “clean share classes”.

More recent data on the costs paid by retail investors for investing in funds comes from the EU supervisor in securities markets. On an annual basis, the European Securities and Markets Authority (ESMA) publishes statistics on the total expense ratios (TER) of UCITS¹⁴² domiciled in the EU in the last year (2020), the last 3 years’ average (2018-2020), the last 7 years’ (2014-2020) and the last 10 years’ (2011-2020).

Table 10. ESMA total expense ratio data

Fund class	Market	2020	2018-2020	2014-2020	2011-2020
	EU	1Y	3Y	7Y	10Y
Equity	EU	1.47%	1.51%	1.59%	1.63%
	NL	0.52%	0.61%	0.86%	0.99%
	UK	1.26%	1.30%	1.41%	1.46%
Bonds	EU	0.98%	1.01%	1.08%	1.09%
	NL	0.57%	0.58%	0.62%	-
	UK	0.96%	1.00%	1.07%	1.10%
Mixed	EU	1.49%	1.52%	1.55%	1.54%
	NL	0.64%	0.71%	0.87%	0.90%
	UK	1.27%	1.32%	1.42%	1.45%
Alternative	EU	1.51%	1.58%	1.64%	1.57%
	NL	-	-	-	-
	UK	0.89%	0.95%	1.08%	1.18%

¹⁴¹ Good Value for Money, ‘Benchmark 2021 des frais facturés au sein des unités de compte’ (16 July 2017, [goodvalueformoney.eu](https://www.goodvalueformoney.eu/newsletter-50-good-value-for-money-benchmark-2021-des-frais-factures-au-sein-des-unites-de-compte)) Newsletter no. 50, available at: <https://www.goodvalueformoney.eu/documentation/newsletter-50-good-value-for-money-benchmark-2021-des-frais-factures-au-sein-des-unites-de-compte>.

¹⁴² The most popular and common legal form for investment funds, i.e. *undertaking for collective investment in transferable securities*.

MMF	EU	0.19%	0.20%	0.23%	0.27%
	NL	-	-	-	-
	UK	0.14%	0.17%	-	-

Source: ESMA Annual Statistical Report on Cost & Performance of Retail Investment Products in the EU (2021)

The most striking differences between the total expense ratios of NL-domiciled UCITS and the EU average can be observed for equity and mixed UCITS, in 2020:

- NL-based funds were almost three-times cheaper than the EU average;
- in the long-term (last 10 years), NL-based UCITS eroded 40% less of the nominal gross returns of EU investors compared to the EU average;
- within the limit of data availability, UK-domiciled UCITS are almost in all cases cheaper (and well below) the EU average, with the exception of bond UCITS between 2011 and 2020.

However, this evidence has a methodological limitation because the data published by ESMA on the total expense ratios does not comprise information for alternative and money-market funds in the Netherlands.

EFFECTS OF BANNING INDUCEMENTS (UK, NL)

I. UK FCA's analysis of the impact of the ban on inducements¹⁴³

The United Kingdom was the first EU Member State to restrict* the receipt of remunerations by providers of retail investment services or products from third parties, since 2012.

**The ban was adopted through the Retail Distribution Review (RDR) and the Financial Advice Market Review (FAMR), which were launched by the Financial Services Authority¹⁴⁴ and HM Treasury. The first set of restrictions (RDR) took effect at the end of 2012 and the second (FAMR) took effect in 2015, building on the work and experiences learnt from the RDR.*

The main arguments were that commission-based investment services (or the distribution thereof) led to poor outcomes for consumers and firms and inherent conflicts in efficient markets. Based on the written evidence submitted to the UK Parliament, the FCA put forward a set of reasons behind the RDR:

- monetary incentives lead to a situation where “the adviser’s interests are often aligned with the provider, not the customer”,
- poorer competition on the market (i.e., based on who paid the most),
- large values lined to consumer detriment (estimated between £400 - £600 million annually), and
- low trust or credibility in financial advisors.¹⁴⁵

¹⁴³ UK Financial Conduct Authority, *Evaluation of the Impact of the Retail Distribution Review and the Financial Advice Market Review* (December 2020) available at: <https://www.fca.org.uk/publication/corporate/evaluation-of-the-impact-of-the-rdr-and-famr.pdf>.

¹⁴⁴ The Financial Services Authority was the predecessor of the Financial Conduct Authority in the United Kingdom; the FSA was divided into the FCA and the Prudential Regulation Authority (PRA) as part of the Bank of England.

¹⁴⁵ “Retail Distribution Review” - Written evidence submitted by the Financial Conduct Authority to the Treasury Committee of the UK Parliament, session 2010-11, available at <https://publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/writrev/rdr/m128.htm>.

In the following years, the UK Financial Conduct Authority¹⁴⁶ commissioned and conducted several supervisory exercises to determine the effects of banning remunerations from third parties in retail financial services.

In 2014, a study meant to analyse how the ban on inducements affected the demand for investment advice, the elasticity of the advice market to adapt to the new demand and the accessibility of advice to retail clients, found **no advice gap** in the UK market, but on the contrary an “*excess capacity (or a negative advice gap)*”; the only caveat was highlighted for individual consumer segments, for which data unavailability made it difficult to draw straightforward conclusions.¹⁴⁷

In 2018, the EC study on distribution systems of retail investment products also suggested that the introduction of ban on inducements helped improving the situation of consumers in the UK (and NL) in terms of access to independent advice, access to information, lower costs: “*generally, local investors have become more cost-sensitive and better informed about investment products*”.¹⁴⁸

In the latest report¹⁴⁹ on the implementation of the inducements ban produced by the UK Financial Conduct Authority, the following key findings are relevant:

- since 2017, an extra 1 million UK consumers accessed advice in 2020 (3.1 million in 2017 vs 4.1 million in 2020 => +32.25%);
- of the UK consumers accessing advice, 56% were satisfied with the service received vs 48% in 2017;
- the most common reason for not seeking advice is that consumers believe they don't need it (67% of cases);
- only 10% of consumers surveyed stated that they cannot afford financial advice;
- consumers are often not encouraged to seek advice;
- the differences in asset allocation (*simplified*) between consumers who received advice and those who received no form of investment support;
- UK traditional advisors charge on average 0.8% p.a. for ongoing advice and 1.1% for the investment portfolio charges => an average of 1.9% in total costs for UK consumers, whereas EU consumers pay on average 2.4% for unit-linked insurance-based investment products;
- robo-advisors are twice cheaper than traditional advisors.
- the analysis also shows that there are no noticeably different features between more expensive / cheaper advice (0.5% vs 1% for ongoing advice and 2% vs 3% costs for initial advice).

¹⁴⁶ The Financial Conduct Authority (FCA) is the successor of the Financial Services Authority (FSA), as explained in footnote no. 7 above.

¹⁴⁷ The report highlights that “There may therefore be a gap in the provision other forms of financial advice or guidance to less affluent segments”.

¹⁴⁸ Page 5 Executive summary: Seeking advice from non-independent advisors via banks and insurers remains the norm for the average retail investor in most Member States where mystery shops were conducted (...) In contrast, the situation in the UK and Netherlands differs substantially from other markets probably due to the introduction of ban on inducements. We found that in UK profile A mystery shoppers (with 10.000 EUR to invest) were redirected by all the banks and insurance companies to Independent Financial Advisors who indeed accepted to receive them and did provide advice regardless of the investment amount. In the Netherlands, mystery shoppers were systematically redirected to the institutions' websites where they could invest on their own, in execution-only mode. Page 11: The regulators in the UK and the Netherlands introduced specific national regulations which, among others, introduced a ban on inducements. These regulations have had a substantial impact on the national investment landscape and led to a shift in investor behaviour from obtaining advice through banks and insurers to retail investors either taking investment decisions on their own through on-line investment platforms or obtaining advice through IFAs: https://ec.europa.eu/info/sites/default/files/180425-retail-investment-products-distribution-systems-summary_en.pdf.

¹⁴⁹ Financial Conduct Authority, *Evaluation of the Impact of the Retail Distribution Review and the Financial Advice Market Review* (December 2020), available at: <https://www.fca.org.uk/publication/corporate/evaluation-of-the-impact-of-the-rdr-and-famr.pdf>.

II. Netherlands inducements' ban aftermath

Inducements for retail investment services have been banned in the Netherlands in 2013, with the restriction coming into force in 2014. The ban prohibits the receipt of remunerations by investment professionals from third parties that directly relate to the provision of investment services and ancillary services to retail (non-professional) clients.

Several studies have been commissioned since then to assess the effectiveness of this restriction. In a speech given shortly after the ban, a representative of the Dutch supervisory authority (AFM) highlighted that the costs for execution-only services decreased threefold (from 0.25% to 0.75%), which represented €300 million in savings for retail investors in the Netherlands; moreover, the AFM also noted that services have diversified (execution-only and full advice) and that product competition increased.¹⁵⁰

According to a 2018 briefing¹⁵¹ of the Dutch Minister of Finance to the Parliament on the effectiveness of the inducements ban, the measures to prevent investment advisors from receiving third party-remunerations for services provided to clients have had positive effects:

- the ban has received broad support, also from investment advisers;
- clients' interests are better served and safeguarded;
- a direct steering towards certain products has ended;
- no problems have been identified regarding the accessibility of advice;
- savers' willingness to pay for advice increases when advisors are given the opportunity to explain what the value added of their service is;
- at the same time, the demand for execution-only services has increased.

Concerning the quality of advice, while the evaluation highlighted a broad increase, it also underlined that a clearer distinction between a recommendation from a provider and independent advice would benefit both consumers and independent advisors. While market participants surveyed in the evaluation held that consumers are not willing to pay for advice (expect it to be free), the evaluation actually found that consumers' choice of advisors is not impacted by the cost of the advisor or distribution channel because consumers do not have a clear view, and do not make comparisons, on the market.

Evidence from BETTER FINANCE Survey

In 2019, BETTER FINANCE conducted a survey with individual, non-professional savers and its member organisations about the experience and level of satisfaction with the new financial markets regulations, i.e. MiFID II and PRIIPs, which both came into force in January 2018. The report, *MiFID II and PRIIPs Implementation Survey*, sought the input on a range of general and more detailed aspects regarding the two mentioned regulatory frameworks, such as the overall assessment of the new cost or performance information etc. Among others, BETTER FINANCE included a question that also relates to investment advice and conflicts of interests, i.e. "On which of the following areas do you see room for improvement?", with one of the possible answers being "quality of advice" and the "suitability assessment and questionnaires".

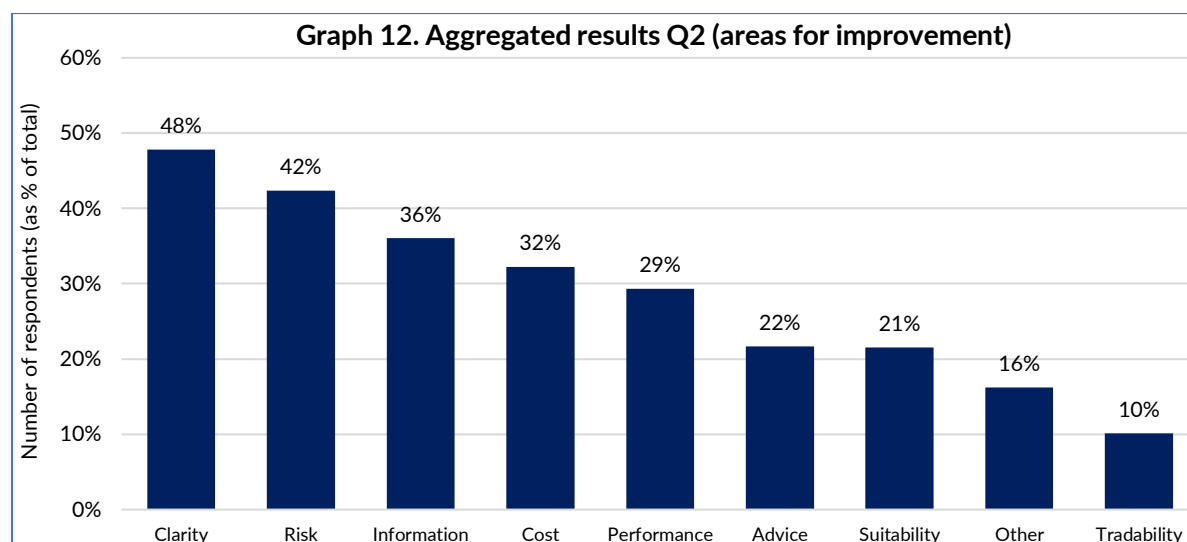
The question – and answers – were very much simplified as individual, non-professional investors cannot be held to the same standard of knowledge (of jargon or of the applicable law)

¹⁵⁰ Speech by Theodore Kockelkoren, 18 November 2014, available at: <https://www.afm.nl/en/nieuws/2014/nov/speech-tk-ban-inducements>.

¹⁵¹ Briefing of the Dutch Minister of Finance to the Parliament of the Netherlands concerning the effectiveness of the inducements ban, 32 457, 23 January 2018, *Brief van de Minister van Financiën, Vergaarderjaar 2017-2018*, available at: <https://www.tweedekamer.nl/downloads/document?id=6eba7576-c347-4c73-aaae-74501faaae10&title=Evaluatie%20provisieverbod.pdf>.

as professionals. However, through “*quality of advice*” and “*suitability assessment and questionnaires*” we sought to learn if “retail” investors are satisfied with the investment advice process, without suggesting any particular aspect to focus on, such as disclosures of conflicts of interests or inducements.

The results, divided between *individual respondents* (retail investors) and *member organisations*, are relayed below.



*Source: BETTER FINANCE, 2020; *the full names of the topic categories are: clarity/intelligibility of information; amount of information; risk transparency; cost transparency; performance transparency; suitability assessment and questionnaires; quality of advice; tradability of securities; other.*

On a general level, 22% of individual respondents consider that the quality of advice must improve which is high, given the general high portion of retail savers that are unaware of issues such as biased or conflicted advice. At the same time, most respondents indicated that the level of *clarity of information* (48%) must improve, and 21% indicated that also the *suitability assessment and questionnaires* must be reformed.

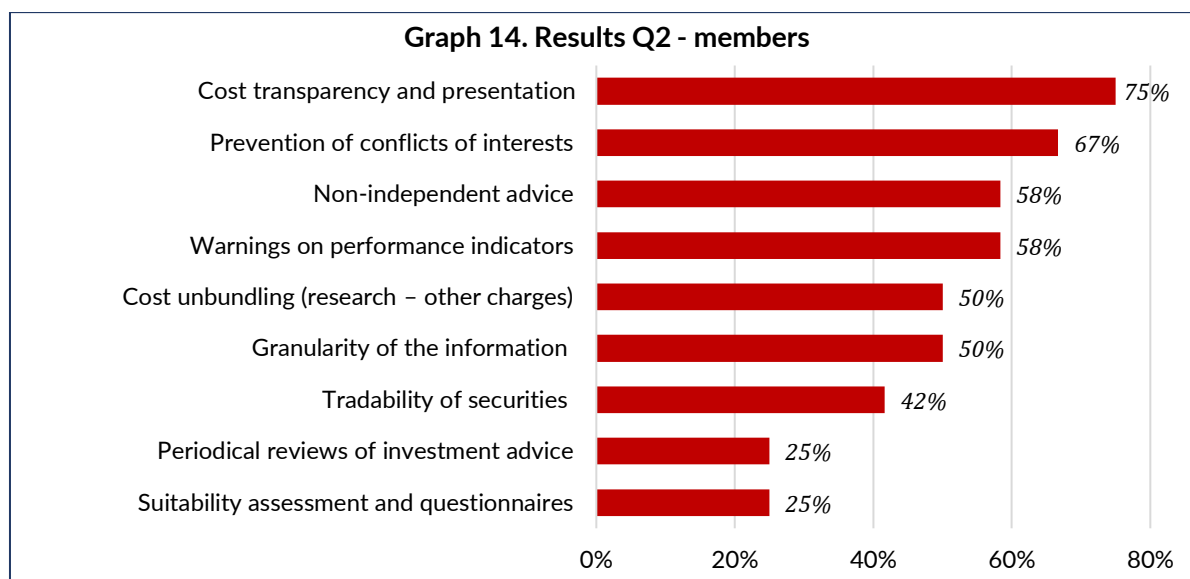
Looking at the differences across jurisdictions, we see diverging views from individual respondents: in Portugal, more than half of surveyed investors believe that the quality of advice must be improved, compared to Finland where only 15% ticked this answer.

Table 13. Results Q2 (areas of improvement) by jurisdiction					
Topic	FI	DE	PT	FR	DK
Clarity/intelligibility of information	43%	43%	78%	67%	38%
Amount of information	24%	39%	51%	38%	43%
Risk transparency	51%	28%	76%	48%	56%
Cost transparency	26%	27%	71%	40%	34%
Performance transparency	31%	24%	47%	36%	28%
Suitability assessment and questionnaires	27%	24%	8%	15%	12%
Quality of advice	15%	20%	57%	22%	18%
Tradability of securities	14%	5%	8%	11%	24%
Other...	13%	22%	10%	3%	13%

Source: BETTER FINANCE, 2020

Among BETTER FINANCE member organisations, we can observe, in fact, that the *prevention of conflicts of interests* and *non-independent advice* rank among the three areas where most members see room for improvement: 67% of BETTER FINANCE members agree that EU law

must do more to prevent, not manage or disclose, conflicts of interests, and 58% consider that non-independent advice is an issue that needs to be tackled.



Source: BETTER FINANCE, 2020

POLICIES SIMILAR TO A BAN ON INDUCEMENTS

I. Australian ASIC ban on commissions for retail clients

The UK and the Netherlands are not the only two jurisdictions to ban the receipt of inducements in relation to services or products provided to retail savers. In Australia, advisors are not allowed to receive commissions for superannuation funds (used for pension purposes) and ordinary investments, with the exception of life insurance products, where this is allowed. The change occurred in 2012, but according to recent publications as of 2021 not even “grandfathered” commission arrangements are allowed anymore.

However, an interesting aspect in the regulation of advice in Australia is that moreover, if the retail client finds the advice received *unsuitable*, he is entitled to a refund, which is possible as an additional measure against mis-selling (additional to an inducements ban). According to a press statement by the ASIC of June 2021, “six of Australia’s largest banking and financial services institutions” compensated consumers for “loss or detriment because of fees for no service misconduct or non-compliant advice” a total of CAD 1.89 billion (€1.27 billion).¹⁵²

II. US SEC “Best Interests Regulation”

In 2019, the US Securities and Exchange Commission (SEC) adopted the “Best Interests Regulation” (regulating the client – broker-dealer relationships)¹⁵³ to ensure that the quality of recommendations is improved and establish a level-playing field with investment advisers’ fiduciary standard. The SEC argued two very important elements in this standard of conduct for broker-dealers:

- the advice (*recommendation*) must meet “*retail customers’ reasonable expectations*”,

¹⁵² ASIC Media Release, ‘21-203MR ASIC Update: Compensation for Financial Advice Related Misconduct as of 30 June 2021’, accessed 30 September 2021, available at: <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2021-releases/21-203mr-asic-update-compensation-for-financial-advice-related-misconduct-as-at-30-june-2021/>.

¹⁵³ Securities and Exchange Commission, Regulation Best Interests: The Broker-Dealer Standard of Conduct, 17 CFR, Part 240, Release No. 34-86031; File No. S7-07-18 RIN 3235-AM35, available at: <https://www.sec.gov/rules/final/2019/34-86031.pdf>.

- it outlines instances where “**disclosure is insufficient to reasonably address the conflict**”,¹⁵⁴
- it obliges broker-dealers to “*act in the best interest of the retail customer (...) without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer*”.¹⁵⁵

First of all, the best interest standard for broker-dealers is one step ahead of EU’s MiFID II policy on conflicts of interest and inducements because it provides a definition for conflicts of interest, i.e. “*an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer – consciously or unconsciously – to make a recommendation that is not disinterested*”.¹⁵⁶

Second, the US SEC Regulation bans, by default, certain practices that give rise to conflicted investment services since “*disclosure is insufficient to address the conflict*”. BETTER FINANCE also argues in its MiFID II position paper that disclosure, for several reasons, is not enough to address the potential adverse effects of conflicts of interest.

Last, the new rules amending the Securities Exchange Act add the element of “*reasonable expectations*” for non-professional clients, which can be a very useful supervisory and private enforcement tool against mis-selling. If applied correctly, it can address many loopholes used to justify non-independent recommendations (sales pitches), such as the mere provision of an additional service or feature that does not substantially increase the quality of the recommendation.

III. Canada ASC ban of inducements in execution-only services

In 2019, the Canadian federal regulatory authority on financial services (Canadian Securities Administrators, CSA) adopted a ban that prohibits fund providers from paying sales commissions to dealers. In more detail, the CSA prohibited “*the payment of upfront sales commissions by fund organizations to dealers, and in so doing, discontinue sales charge options that involve such payments, such as all forms of the deferred sales charge option, including low-load options*”.¹⁵⁷

In the Consultation Paper that preceded this measure, the CSA included research on *evidence of harm to investors protection and market efficiency from embedded commissions*,¹⁵⁸ which collected literature and surveys or experiments on the topic from a broad range of views.

Among the research papers quoted, we highlight some of the clear key messages below:

- while fund sales are normally sensitive to past performance (i.e., *investors buy well performing funds and sell poorly performing ones*), this sensitivity is reduced when fund managers pay commissions;¹⁵⁹
 - this means that the bigger the commission paid, the bigger the inflows into the fund, despite the fact that the fund is poorly performing;¹⁶⁰

¹⁵⁴ Emphasis added.

¹⁵⁵ Emphasis added.

¹⁵⁶ US Securities and Exchange Commission, *Regulation Best Interests: A Small Entity Compliance Guide* (sec.gov) accessed 28 September 2021, available at: <https://www.sec.gov/info/smallbus/secg/regulation-best-interest>.

¹⁵⁷ CSA Staff Notice 81-332 – Next Steps on Proposals to Prohibit Certain Investment Fund Embedded Commissions, 19 December 2019, available at: https://www.osc.ca/sites/default/files/pdfs/irps/csa_20191219_81-332_next-steps-proposals-prohibit-certain-investment-fund-embedded-commissions.pdf.

¹⁵⁸ CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions, 10 January 2017, Appendix A, p. 97, available at: https://www.osc.ca/sites/default/files/pdfs/irps/sn_20170110_81-408_consultation-discontinuing-embedded-commissions.pdf.

¹⁵⁹ After D. Cummings, S. Johan, ‘A Dissection of Mutual Fund Fees, Flows, and Performance’ (8 February 2016), available at: https://www.osc.ca/sites/default/files/pdfs/irps/rp_20160209_81-407_dissection-mutual-fund-fees.pdf; the following 4 bulletpoints have the same source.

¹⁶⁰ Ibid.

- of all, deferred sales charges (trailing commissions) have the greatest impact on the fund flow sensitivity to past performance;¹⁶¹
- commissions affect future performance: a trailing commission of merely 1% generates a decrease in **gross** returns by 1.4%;¹⁶²
- what is worse, fund managers who pay commissions cease trying to outperform (at least themselves);¹⁶³
- another study showed that net returns decrease by 0.5% for every 1% of load fees paid;¹⁶⁴
- finally, funds that pay inducements underperform those that do not pay inducements.¹⁶⁵

However, the CSA Consultation Paper provides a very wide and in-depth analysis of the available literature and studies on the effects of embedded commissions in mutual fund sales. Arranged by topics, the excerpt is worth reading for policy makers and supervisors in the EU as it gathers findings on topics such as:

- “*embedded commissions limit investor awareness, understanding and control of dealer compensation costs*”, pp. 113-116;
- “*embedded commissions add complexity to fund fees which inhibit investor understanding of such costs*”, pp. 116-119; or
- “*investors do not receive ongoing advice commensurate with the ongoing trailing commissions paid*”, pp. 122-125.

Later in 2020, the Canadian CSA also adopted a ban on trailing commissions “for dealers who do not make a suitability determination, such as order-execution-only (OEO) dealers” for retail clients, which will be applicable as of 1st of June, 2022.¹⁶⁶ The applicable law provides that dealers cannot recommend an action (“*purchase, sell, hold or exchange any security, including any class of security or the security of a class of issuer*”¹⁶⁷) to a retail client without making a suitability determination. However, an investor advocacy group has challenged the effective date as being “justice being denied through delay”, especially in light of several cases and class actions against excessive, non-transparent or hidden fees paid to brokers.¹⁶⁸

The ban effectively means that trailing commission payments, paid by fund managers, portfolio advisers and principal distributors of publicly offered mutual funds, or solicited or accepted by dealers of the former, are no longer allowed.

BETTER FINANCE Position

To begin with, the term used (“inducement”) to denominate these rewards (commissions, kickbacks, rebates, or other remunerations) paid to intermediaries for a service provided to a retail client is likely to be seen by non-professional savers as jargon and it is not illustrative of

¹⁶¹ After D. Cummings, S. Johan, ‘A Dissection of Mutual Fund Fees, Flows, and Performance’ (8 February 2016), available at: https://www.osc.ca/sites/default/files/pdfs/irps/rp_20160209_81-407_dissection-mutual-fund-fees.pdf; the following 2 bulletpoints have the same source.

¹⁶² Ibid.

¹⁶³ Ibid.

¹⁶⁴ After S. K. Christoffersen, R. B. Evans, David K. Musto, ‘What do Consumers’ Fund Flows Maximize? Evidence from Their Brokers’ Incentives’ (2012) Journal of Finance, Forthcoming Darden Business School Working Paper No. 1393289, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1393289.

¹⁶⁵ J. Reuter, ‘Revisiting the Performance of Broker-Sold Mutual Funds’ (2015) Boston College - Department of Finance; National Bureau of Economic Research (NBER), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685375.

¹⁶⁶ See CSA-ACVM, ‘Canadian securities regulators adopt ban on trailing commissions for order-execution-only dealers’ (17 September 2020)

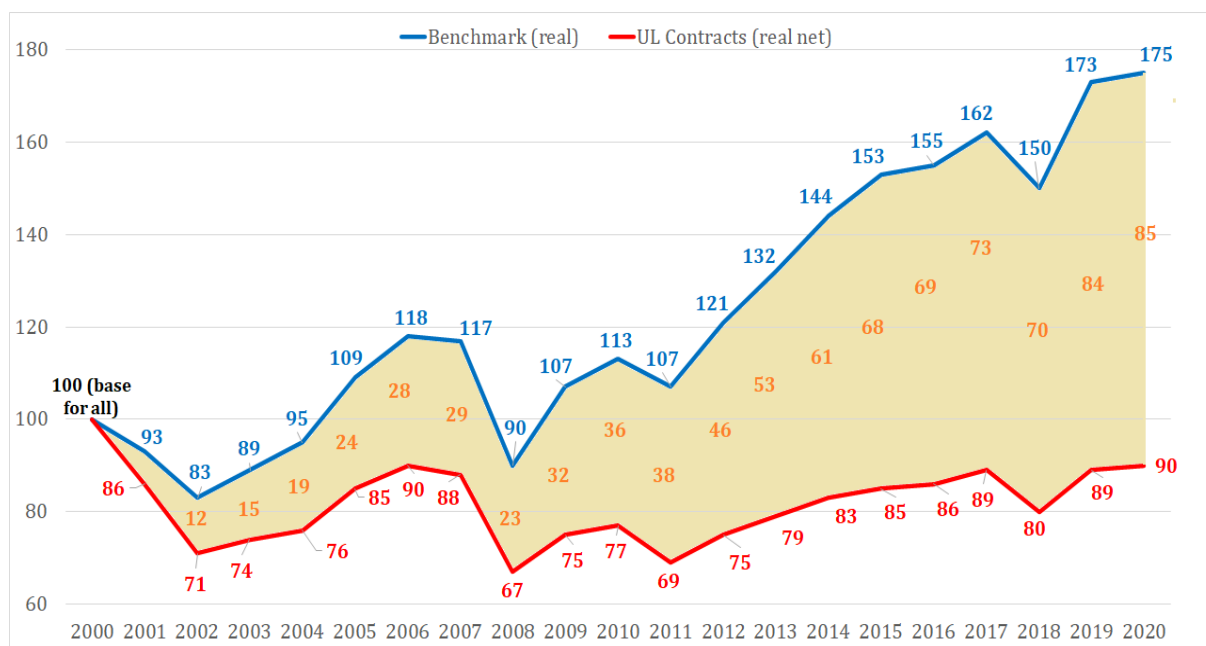
¹⁶⁷ Rule 3404 Exemptions from and Exceptions to Suitability Requirements, 3404(1)(ii), available at: <https://www.iroc.ca/rules-and-enforcement/iroc-rules/3000/3404-exemptions-and-exceptions-suitability-requirements#1849274314-645672842>.

¹⁶⁸ Leo Almazora, ‘Securities Regulators Announce Final Rules to Implement a Ban Aimed at Improving Investor Protections’ (wealthprofessional.ca, 18 September 2020) accessed 30 September 2020, available at: <https://www.wealthprofessional.ca/news/regulators/csa-shutting-the-door-on-trailing-commissions-for-o eo-dealers/333415>.

what it represents. The word itself is not intelligible for the vast majority of retail investors. Therefore, the wording fails to comply with MiFID II rules on clear information. The former chair of EIOPA, Gabriel Bernardino, publicly referred to “inducements” as “kickbacks”, which is a much clearer term for the average retail investor.

BETTER FINANCE asks that this word be changed into an intelligible one for the people and proposes simpler and clearer terms, such as commissions or kickbacks.

Second, BETTER FINANCE sees the receipt of inducements (commissions, kickbacks, rebates, etc) as a source of conflicts of interest as the intermediary (that who receives) will be naturally inclined to follow its commercial interests rather those of its clients. Indeed “inducements” are not only very detrimental to retail investors, they are also a major obstacle to the success of the CMU and of one of its main goal, which is to foster retail investments into capital markets. Below, BETTER FINANCE illustrates an example of the devastating impact on one of the biggest long-term investment products in France, i.e., unit-linked insurance-based investment products (simply, *unit linked life insurances*).



Source: BETTER FINANCE composition based on STOXX, Bloomberg, FFA, Eurostat data; *benchmark (real)* represents the real (after inflation) return of a capital markets benchmark calculated by BETTER FINANCE (50% equities representing the STOXX 600 and 50% bonds representing the Bloomberg Barclays Pan-Euro Aggregate Index, rebalanced annually);

We argue this is because low-cost and simple products, that are closest to capital markets and to the funding of the real economy (such as plain vanilla listed equities and bonds and low-cost plain vanilla ETFs), do not pay any commission (“inducements”) to retail distributors. Therefore, for the last decades, not only have advisors and distributors not explained or a fortiori promoted these investment products (for example, the market of ETFs is 90/10 institutional/retail in the EU versus 50/50 in the US according to ESMA), but even advisors and distributors have little knowledge of those simple low-cost products, since it is not usually their job to deal with them.

However, achieving bias-free advice throughout the EU will require far more effective policy measures than the existing ones.

In an ideal world, there would be no “inducements” since these - by essence - bear the risk of conflicts of interest for the distributor. It is the only way to achieve completely “*bias-free advice*” as targeted by the EC in its CMU Action Plan of 2020. Moreover, many stakeholders believe that “no advice” is better than biased advice.

Why would market participation be affected, let alone decrease, if the commissions were unbundled from the cost of the product? Wouldn't it be the same as when you bring your BMW in for service? You get an invoice where parts and labour are charged separately, right? Why should it be any different for mutual funds? If rational consumers valued the "advice"/support they received from their "advisor" they should be indifferent to how they pay for it, either separately or as part of the cost of the product, right? If this is true, banning commissions across the EU at the minimum, should leave consumer market participation unchanged, not reduce it.

At the end of the day, it is our strong belief that tackling "inducements" head on is necessary if the Commission and Member States truly want to achieve CMU goals and unlock EU citizens' savings.

The EU regulation of financial markets is product-based. If the Commission is willing to make progress towards its stated objectives, it should consider investor/ client-centred regulation.

We ask that the European Commission follows at least the recommendations of the 2020 High Level Forum on the CMU that it set up, comprising 30 members, mostly from the financial industry, and two from the consumer/retail investor side). In particular:

- there should be consistent rules on conflicts of interest for all retail investment products; i.e. ban inducements for "independent advice" and for "portfolio management" not only for MiFID scope investment products (which in effect constitute just about 10% of EU households' financial savings) but also for Insurance-based Investment Products (IBIPs), for personal pensions including PEPP and for occupational pension savings products as well (which constitute all together about 40% of total financial savings).
- in addition, "inducements" should also be banned for execution-only transactions and subscriptions (as done in Canada), since – by definition – they do not include any "advice" service from the provider nor from the distributor.;
- ensure that the developing "clean share classes" of investment funds (lower expense ratio due to the absence of "inducements") are fully and easily available to independent advisors (in the sense of MiFID).
- "non-independent advisors" should be clearly labelled as such in all communications to clients and prospective clients.

At the same time, the EC should review the notion of investment "advice" in EU rules. This is because inducements were never designed to remunerate "advice": they always remunerate the sale of investment products, regardless of whether the sale has also involved "advice", marketing or no additional service. There is a legal confusion between "investment advice" and "sales". Most "inducements" are sales commissions.

To our knowledge, there is no such thing as advice commissions or "payment for advice" by product providers to distributors. Distributors are always and only compensated by providers for selling their products, never for "advising" them: distributors usually receive the same sales commissions (and every year over the whole holding period of the sold product) whether it was an "advised" transaction or an "execution only" one (by definition without any advice).

These moderate policy actions are the minimum requisite to make any significant progress towards the crucial goal of the European Commission: to ensure investors get bias-free advice.

MiFID II creates a confusion between the selling of investment products and investment advice, which should always be independent. The 2018 EC study already confirmed BETTER FINANCE's findings, i.e. that an average individual investor is not able to differentiate between

the benefits and risks of different types of advice. In fact, the study confirms that an average retail investor seeking personal advice would tend to go to non-independent advisors via banks and insurers (believing it's "free" advice and being unaware of incentive schemes and potential conflicts of interest) and end up with relatively similar investment "recommendations" across Member States in terms of product types, i.e., in-house investment funds and life insurance policies¹⁶⁹.

BETTER FINANCE is of the view that prohibiting "inducements" from all advised-services products across the EU may actually lead to an increase in capital market participation. We believe that the "safeguards" imposed by MiFID II (such as the quality enhancement requirement) simply conflict with the overarching requirement to act in the best interest of the client and will leave EU households in the same "saving, but not investing" spiral for the decade to come.

¹⁶⁹ The study confirmed as well that low cost ETFs were rarely proposed by "human" advisors ¹Study on the distribution systems of retail investment products https://ec.europa.eu/info/publications/180425-retail-investmentproducts-distribution-systems_en.

POLICY RECOMMENDATIONS

In order to **ensure access to bias-free advice** for EU households as long-term savers, EU law must ensure that advisers and distributors act in the best interest of their clients, adequately disclose conflicts of interest, and are not allowed to receive monetary remunerations in those situations where disclosure is insufficient to address the detrimental effects for consumers.

Introduce the same MiFID II concepts under IDD and other sectoral legislation

Sectoral legislation for EU retail financial products and services does not have the same level of protection and safeguards for individual, non-professional financial services users. Currently, securities markets (MiFID II) award the highest consumer protection standards, which is still insufficient to ensure “retail” clients benefit from bias-free advice and services that take into account their best interests.

BETTER FINANCE recommends for EU authorities to level the safeguards for the general duty of care (*acting in the client's best interests*) and against conflicts of interest by introducing the same concept of *independent advice*, *execution-only services* (incl. reception and transmission of orders) and *portfolio management* in other relevant EU legislation, such as the Insurance Distribution Directive.

Ban commissions for independent advice, execution-only services and portfolio management in all EU retail investment markets

To ensure that consumers of financial services and products receive the same fair treatment across EU retail investment markets, sectoral legislation must also put in place the same limitations and safeguards for the same concepts. In this sense, BETTER FINANCE recommends EU authorities to:

- ban the receipt (and retaining) of “inducements” for *independent advice*, *execution-only services* (particularly payments for order flows) and *portfolio management* for all categories of EU financial products;
- introduce the same disclosure obligations for *non-independent advice* as under MiFID II (nature, value, calculation of the commissions, presented on an ex-ante basis);
- introduce the same requirements (quality enhancement or additional service) for those professionals that do receive and retain commissions for the distribution of financial products or provision of financial services, as is currently the case under MiFID II.

Introduce a definition for acting in the “client's best interest”

The general duty of care should be defined as “*the ultimate purpose or target of delivering value for money from a financial instrument at the end of the clients' investment horizon or desired holding period*”. In this sense, a product or service would deliver value for money when its characteristics, particularly cost and performance in relation to an appropriate benchmark, enable it to achieve its investment objectives which must be aligned with the profile and needs of the consumer.

Introduce a definition of “conflicts of interest”

These should “*arise when the investment firm, including its staff, has or may have financial or economic interests, both directly or indirectly, to act or take a decision that is contrary to the interest of the client, either short or long-term, irrespective of whether the act or decision is contended or taken and whether damage is caused. When determining the interest of the client, due consideration*

will be given as to whether the interest in question does or does not amount to the investment objective and needs (best interest) of the client".



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Fédération Européenne des Épargnants et Usagers des Services Financiers

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