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Addressing conflicts of interest for a CMU that really "works for people"

The recent Capital Markets Union (CMU) Action Plan, sparked by the COVID-19 crisis, aims to put equities back at the heart of the EU economy funding and reduce the reliance on bank funding. In the aftermath of the global health pandemic, the EU economy will be in dire need of new capital financing in order to stimulate a swift recovery as well as innovation, sustainable investments and growth.

As the main source of long-term capital, EU households have a key role to play. But inviting EU savers to participate more directly in capital markets comes with a certain responsibility: investing in the EU's CMU must be safe, fair, and trustworthy.

To achieve this, the EU must first effectively address conflicts of interest in "retail" financial services (distribution and execution) and create a bias-free environment which stimulates competition and upholds clients' best interests.

BETTER FINANCE has long voiced its concerns regarding the misalignment between the interests of financial services providers and those of their individual, non-professional clients. Perhaps the most detrimental practice in this field is that allowed by "non-independent" advice. Paying commissions or non-monetary benefits to investment advisors for their "advice" (actually for their sales) to "retail" clients has gradually and significantly steered EU households away from direct ownership of the EU economy to packaged, fee-laden financial products, as there are no commissions on listed securities and low-cost index funds (ETFs) – only on more "packaged" retail investment products.

BETTER FINANCE demonstrated how heavily fees weigh on long-term real (after inflation) net returns. Moreover, research by the European Securities and Markets Authority (ESMA), and other research reports, consistently found that – on average - cheaper, passively managed products (e.g., index ETFs) largely outperform the more expensive, actively managed products in net terms.

This high level of fees can largely be blamed on "inducements" because the commission for a non-independent "advisor" (actually a sales person) will eventually be borne by the retail client through the fees paid for the product .More problematic, , receiving remuneration or non-monetary benefits for particular products, creates an inherent conflict of interest between the provider and the client: according to MiFID II, investment firms must "act honestly, fairly and professionally in accordance with the best interests of its clients" (Art. 24).

Besides the conflicts of interest generated by non-independent advice, a recent scandal involving retail equity trading revealed an additional source of conflicts of interest affecting retail investors: the payment for order flows (PFOF). The stand-off between professional and retail investors following the GameStop case shone the spotlight on the issues with PFOF, that were largely ignored before.

PFOF impairs the retail broker's duty to act in the best interest of its clients and to obtain the best possible execution result. A CFA Institute report demonstrated that a ban on PFOF in the UK by the Financial Supervisory Authority led to "an increase in the proportion of retail-sized trades executing at best quoted prices from 65% top 90% between 2010-2014" and also narrowed down price spreads for large cap equities. In addition to poorer execution, PFOF can hinder competition among market makers and securities markets themselves and hurt price formation.

Therefore, BETTER FINANCE recommends to policy makers to urgently ban inducements for all retail investment products (i.e. all "PRIIPs" and pension saving products such as PEPP) as the main source of conflicts of interests in retail financial services, at the very least for independent advice, for portfolio management and for "execution only" transactions. The High Level Forum for the Capital Markets Union has made the same recommendations to the European Commission last year.