

INDEPENDENT INVESTMENT ADVICE UNDER MiFID II¹

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Abstract: *The paper deals with independent investment advice institute under MiFID II. The content of this paper is mainly characterization of the institute and analysis of selected issues associated with its prospective application, along with the distinction of independent and non-independent investment advice. The paper focuses primarily on analysis of assessment of a sufficiently wide range of financial instruments as a conceptual characteristic of independent investment advice. Attention is also given to the question of “limited” independent investment advice. Within the paper the author points out several problematic issues that might lower the legal certainty level of the investment firms providing independent investment advice in the future.*

Keywords: *investment firm, independent investment advice, variety of financial instruments*

INTRODUCTION

In connection with the upcoming, though by one year postponed application date of the MiFID II,² issues related to the new regulation of provision of investment services are becoming increasingly important. Both entirely new legislation, as for example a new category of unregulated market (so-called organised trading facility) and legislation, significantly modifying the existing MiFID³ based European regulatory framework, should be taken into account. This article deals with some of the issues included in the latter area.

These are the new rules for investment advice as one of investment services under MiFID II. Deepening regulation of the provision of this investment service, whose essence is provision of personal recommendations to clients regarding financial instruments or transactions with financial instruments, is justified by the growing importance of investment advice to retail clients⁴ and belongs to the most important changes that the new Eu-

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² 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. On February the 10th 2016, the European Commission proposed a draft directive, extending by one year the application date of MiFID II. See European Commission [online]. 2016. [2016-02-22]. Commission extends by one year the application date for the MiFID II package. Available at: http://europa.eu/rapid/press-release_IP-16-265_en.htm?locale=en. Such possibility was openly discussed within the industry already in the previous months. See JESCH, T. A. *MiFID II – Zurück in die Zukunft. Recht der Finanzinstrumente* [online]. 2015. [2016-01-30]. Available at: <http://finanzen.ruw.de/rdf-news/standpunkte/MiFID-II--Zurueck-in-die-Zukunft-28613> or VERLAINE, J. A. *Banks May Get Extra Time to Soften Up EU Financial-Market Rules*. Bloomberg Business. [online]. 2015. [2016-01-30]. Available at: <http://www.bloomberg.com/news/articles/2015-11-10/eu-commission-proposes-to-delay-mifid-ii-rules-by-a-year>.

³ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

⁴ See Rec. 70 MiFID II.

European legislation brings to the area of investment services provided to this category of clients. It must be noted that the regulation of investment advice under MiFID II is not a revolution but rather an evolution of the existing European legislation. Existing and according to the European legislator functional regulatory framework is therefore only deepened and at the same time enhanced by some hitherto unknown institutes. One of these is the independent investment advice.

Within the scope of the article, I will focus both on the characteristics of this institute in terms of European financial law and the analysis of one of the conceptual characteristics of independent investment advice, namely the assessment of a sufficiently wide range of financial instruments. I will also briefly refer to the related problems. With regard to the delay of the European Commission in the release of Delegated acts, the presented analysis of the issue must currently be based directly on the MiFID II and also take into account documents issued by ESMA,⁵ namely the Technical Advice, which serves as a relevant basis for creating the final version of the respective Delegated act.⁶

DISTINCTION OF INDEPENDENT AND NON-INDEPENDENT INVESTMENT ADVICE

In comparison with MiFID I, the definition of investment advice remains unchanged. The basic novelty introduced by MiFID II in the area of investment services with an advisory element presents the institute of independent investment advice.⁷ This institute, which is as *Honorar-Anlageberatung* known, for example, to German legal order⁸ and which is typical for the investment services market in the UK, presents an alternative to the in practice widespread model of by brokerage fee covered investment advice, prevailing besides the already mentioned Germany⁹ for example also in the market practice of the Czech Republic. The aim of enactment of the independent investment advice institute is to establish an easily recognizable category of service, where the possibility of a conflict of interest is excluded.¹⁰

Although the relationship between independent and non-independent investment advice is not apparent at a first glance, I consider that the independent investment advice should be understood not as a contradiction to the non-independent, by brokerage fee

⁵ European Securities and Markets Authority, hereinafter “ESMA”.

⁶ ESMA [online]. 2014. [2016-02-10] ESMA's Technical Advice to the Commission on MiFID II and MiFIR. Available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf, hereinafter “ESMA's Technical Advice”.

⁷ See Art. 24 (4) a) point i) MiFID II.

⁸ See s. 31 Abs. 4b Gesetzes über den Wertpapierhandel (Wertpapierhandelsgesetz - WpHG) vom 9. 9. 1998 (BGBl. I S. 2708) and Gesetz zur Förderung und Regulierung einer Honorarberatung über Finanzinstrumente (Honoraranlageberatungsgesetz) vom 15. 7. 2013 (BGBl. I S. 2390). The institute is used in a limited way in the German market practice.

⁹ KURZ, A. I. MiFID II – Auswirkungen auf den Vertrieb von Finanzinstrumenten. *Der Betrieb*. Düsseldorf: Handelsblatt Fachmedien GmbH, 2014, Vol. 67, No. 21, p. 1183.

¹⁰ GRUNDMANN, S. Wohlverhaltenspflichten, interessenkonfliktfreie Aufklärung und MiFID II: jüngere höchstgerichtliche Rechtsprechung und Reformschritte in Europa. *WM – Wertpapiermitteilungen*. Frankfurt am Main: Herausbergemeinschaft Wertpapier-Mitteilungen, Keppler, Lehmann, 2012, Vol. 66. No. 37, p. 1753.

covered investment advice, but like its superstructure, both in the area of conduct of business rules and, at least potentially, in the qualitative area. This conclusion is supported by both the systematic position of the institute within the framework of the Directive, where general rules are common to both investment advice regimes and provisions ensuring the independence of investment advice are in the position of special legislation, and the opinions of certain representatives of the professional community.¹¹

Although MiFID II creates prerequisites for independent investment advice to become an investment service with higher added value to more informed and more demanding part of retail clients, in my opinion, it is not possible to automatically deduce from this fact that independent investment advice will be, according to the client's perspective, always of a higher quality than non-independent investment advice, especially in cases where the investment firm materially meets all the requirements laid down by MiFID II for independent investment advice (see below), but will be (albeit partially) remunerated by brokerage fees paid by financial institution, whose investment products the respective client includes in his investment portfolio based on the recommendations of the respective investment firm.

Concerning distinction between both regimes of investment advice, MiFID II leaves the initiative on the side of the industry. Investment firms have the autonomy of choice whether they will provide investment advice on an independent or non-independent basis, they are, however, always obliged to disclose to their clients in a good time before the actual provision of investment advice the regime of the investment advice provided. Such information should clarify whether and why investment advice could qualify as independent and which restrictions therefore apply.¹² In case the same investment firm offers its clients both types of investment advice, which is generally admissible under the Directive, it is firstly obliged to explain to the clients the difference between the two types of investment advice and secondly should avoid presenting itself in general as an independent investment advisor or emphasize its independent investment advice services over the non-independent when dealing with a client.¹³ Within its organizational structure, the investment firm is also required to separate clearly both types of investment advice provided and individuals providing the advice (so called Chinese walls), in particular it is required in order to prevent the risk of confusing the client to ensure that the relevant individual is not allowed to provide independent and non-independent investment advice.¹⁴ Compliance with this requirement could be problematic particularly for smaller investment firms and may lead to the need to choose one of both types of investment advice provided for business of the respective investment firm as a whole. The consequence of presenting the investment advice provided to the client as independent is then the necessity to comply with related regulatory standards in relation to such client.¹⁵

¹¹ CAVROIS, J. P. *Independent advice under MiFID II*. Contribution within the conference MiFID II: Latest Developments for Practice, held by the Academy of European Law in Trier on 22nd–23rd of October 2105.

¹² ESMA's Technical Advice, p. 108.

¹³ ESMA's Technical Advice, pp. 108–109.

¹⁴ ESMA's Technical Advice, p. 148.

¹⁵ Art. 24 (7) MiFID II.

What makes independent investment advice independent?

The regulatory regime of independent investment advice is a superstructure of the general regime in three following levels: the level of variety of financial instruments considered,¹⁶ the level of taking into account the relationship between respective investment firm and providers, issuers or distributors of financial instruments considered within the provided investment advice¹⁷ and finally in the level of inadmissibility of receiving incentives related to the provided investment advice.¹⁸ To the latter point can be with respect to focus of the article only briefly noted that the investment firm shall not in case of providing independent investment advice accept or retain any fees, commissions or any monetary or non-monetary benefits (i.e. incentives) paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the respective service to clients.¹⁹ Although the above mentioned characteristics of independent investment advice are directly determined by the Directive, their concretization in the Delegated act is assumed. The Delegated act should take into account the already mentioned ESMA's Technical Advice. With regard to the aforementioned delay of European Commission with the release of the delegated acts for MiFID II, for the time being it is necessary to take into account the ESMA's Technical Advice and at the same time draw attention to the fact that the respective Delegated act can still change a lot.

The range of assessed financial instruments

The fundamental characteristic of independent investment advice, along with the above mentioned restriction on receiving incentives from third parties,²⁰ is the requirement on quality of the analysis provided within the investment advice. Where an investment firm informs the client that investment advice is provided on an independent basis, it shall assess a sufficient range of financial instruments available on the market. Financial instruments should be diverse with regard to their type and issuers or providers and should not be limited to financial instruments issued or provided by entities with a close link or other close legal or economic relationships to the investment firm.²¹ This rather abstract rule applicable exclusively in the case of independent investment advice relates to a similarly formulated rule applicable to investment advice under MiFID II in general, which requires specifying the extent of analysis provided within the investment advice.²² Formulation of the rule raises several difficulties of interpretation.

Above all, the definition of the extent and composition of the spectrum of assessed financial instruments or other investment products necessary to fulfil the requirement of

¹⁶ Art. 24 (7) a) MiFID II.

¹⁷ Art. 24 (7) a) point i) and ii) MiFID II.

¹⁸ Art. 24 (7) b) MiFID II.

¹⁹ Art. 24 (7) b) MiFID II.

²⁰ Art. 24 (7) b) MiFID II.

²¹ See Art. 24 (7) a) point i) and ii) MiFID II. A close link is defined by the Art. 4 (1) point 35) MiFID II and simplified means the control relationship between entities or participation of at least 20% of the voting rights or capital of an entity.

²² See Art. 24 (4) a) point ii) MiFID II.

sufficiency and diversity within the meaning of the Directive appears problematic. Teleological interpretation in the context of the preamble of MiFID II brings a not very useful specification, according to which it is not necessary to assess investment products available on the market by all product providers or issuers.²³ It is however apparent that such a requirement would be very difficult to implement in most cases. Unclear is the question whether it is necessary to include into assessment under Article 24 (7) a) MiFID II solely financial instrument as the object of regulation of MiFID II, or investment products, different from financial instruments or even other financial products, such as standard bank deposits, insurance-based investment products etc.

Possible requirement to assess also other investment or financial products derives from recital 73 of MiFID II, but the legal text of the Directive itself refers in this context only to financial instruments.²⁴ Using the grammatical and systematic interpretation and having regard to the scope of MiFID II, I reach the conclusion that the requirement to assess a wide range of products according to the mentioned recital applies exclusively to financial instruments within the meaning of Annex I Section C of the Directive. It does not, however, exclude the possibility of the investment firm to take into account other categories of financial products under the loyalty principle as well, especially if the respective investment firm is entitled to their distribution.

The sufficiency of width of variety of financial instruments considered should, under the consideration of EU legislator, be assessed primarily in relation to the link between the investment firm providing investment advice and the issuers or providers of the recommended financial instruments.²⁵ However, as is apparent from the EMSA's Technical Advice, which is very likely to be reflected in the final text of the delegated act of the European Commission, this criterion is not the only indicator that an investment firm providing independent investment advice shall take into account in order to fulfil the requirement posed on the sufficiency of the provided analysis.

When assessing the suitable financial instruments, the investment firm providing independent investment advice shall take into account the fulfilment of the following five criteria, related primarily to the variety of financial instruments considered, their category and other characteristics. These are the following criteria:

1. assessment of wide range of financial instruments diversified by type, issuer or provider, not limited to financial instruments provided by related entities,
2. the number and variety of financial instruments considered is proportionate to the scope of advice services offered by the investment firm providing independent investment advice,
3. the number and variety of financial instruments considered is adequately representative of financial instruments available on the market,
4. the quantity of financial instruments issued by the investment firm itself or by entities closely linked to the investment firm itself is proportionate to the total amount of financial instruments considered,

²³ See Rec. 73 third sentence MiFID II.

²⁴ See Art. 24 (7) a) MiFID II.

²⁵ See. Rec. 73 fourth sentence MiFID II.

5. criteria of comparison include risks, costs and complexity of financial instruments and take into account characteristics of client to prevent provision of biased recommendations.²⁶

In case the above mentioned requirements cannot be fulfilled, for example because of the business model or the specific scope of the advice provided, the investment firm providing advice should not be allowed to claim itself as independent.²⁷

“Limited” independent investment advice

Investment firms focusing on certain categories or a specified range of financial instruments can benefit from mitigation of the aforementioned relatively strict rules brought by ESMA’s Technical Advice. The definition of these specific categories or specific range of financial instruments could be problematic. I believe that it is necessary to take into account both the category of financial instruments within the meaning of Annex I Section C MiFID II, as well as other legal or economic criteria, such as particular industry, to which the financial instrument relates.²⁸ In such case the investment firm shall present itself in a way that firstly only attracts clients with a preference for such specific category or a range of financial instruments and secondly enables the clients to easily identify such focus of the investment firm with a high degree of accuracy. In such case the clients should indicate that they are only interested in investing in the specified category or range of financial instruments and the investment firm should be able confirm that its limited business model matches the client’s needs and objectives and the range of financial instruments is suitable for the client, otherwise the independent investment advice shall not be provided.²⁹ In this context, it might be possible to talk about a kind of limited independent investment advice. The ESMA’s approach modified some previous views, based on the principle that the substantive restriction regarding the variety of financial instruments considered excludes *per se* the provision of independent investment advice.³⁰

CONCLUSION: SELECTED PROBLEMATIC ASPECTS OF INDEPENDENT INVESTMENT ADVICE

A relatively high level of multivalence, which could result in the reduction of legal certainty of the addressees of the new legislation and could cause application problems, is characteristic for some of the above mentioned requirements of MiFID II and ESMA set down on the analysis provided within the independent investment advice. This fact is especially noticeable by the requirements of ESMA according to the point 1 to 3 above, implementing Article 24 (7) a) MiFID II. The primary criterion for assessing the sufficiency of variety of financial instruments considered within the independent investment advice is the limitation

²⁶ ESMA’s Technical Advice, p. 147.

²⁷ ESMA’s Technical Advice, point 2, p. 147.

²⁸ This might include the provision of independent investment advice restricted to shares and bonds issued by companies operating in the sector of information technology, automotive, etc.

²⁹ ESMA’s Technical Advice, point 3, p. 147.

³⁰ LOFF, D., HAHNE, K. D. Vermögensverwaltung und Anlageberatung unter MiFID II: Neuregelungen, Gestaltungsmöglichkeiten und deren steuerliche Implikationen. *WM – Wertpapiermitteilungen*. Frankfurt am Main: Herausbergemeinschaft Wertpapier-Mitteilungen, Keppler, Lehmann, 2012, Vol. 66. No. 32, p. 1519.

of consideration solely on the financial instruments issued or provided by a related entity,³¹ a secondary criterion is then the type of financial instruments considered.

Under the term type of financial instrument can be understood partly, and in my opinion primarily, the category of the financial instrument within the meaning of the relevant annex of MiFID II (transferable securities, units in collective investment undertakings etc.), partly other characteristics that are not based on the technical structure of the respective financial instrument, for example, its connection to a specific industry or a specific region.

In case the investment firm is interested in providing independent investment advice in full, not limited scope, it should be capable to take into account all aforementioned relevant criteria when creating the variety of considered financial instruments. Besides, in accordance with the loyalty principle, the firm should be able to prove the actual performance of the mentioned assessment. This fact raises a question whether such requirements will not be too burdensome for the majority of investment firms and if the institute of independent investment advice will be a success in practice compared to the non-independent investment advice.

An unanswered question further remains whether the independent investment advice regime can be applied in case that MiFID II directly prohibits the investment advice provider to take into account certain categories of financial instruments, regardless of their further characteristics. This is the case of investment services providers operating in the national regime on the basis of optional exemption specified in Article 3 MiFID II. These entities, which include, for example, institute of an investment intermediary under the legal order of the Czech Republic,³² are, based on MiFID II and implementing national legislation, not authorized to provide investment advice to other than listed categories of financial instruments.³³ Having regard to the mentioned limitation in relation to certain categories of financial instruments, I come to conclusion that in case of these entities only limited independent investment advice or non-independent investment advice can be considered, because of the fact that such entity will not be, unlike the harmonized investment firm, able to assess a wide range of financial instruments diversified by type and category due to the limitations set down at the level of the Directive itself.

It is apparent that many of the mentioned problematic questions can hardly be answered without specification of rules laid down by the Directive in the Delegated act, which is eagerly awaited by the industry. In the current state of things, I am afraid that the uncertainties and the associated legal uncertainty could significantly weaken the interest of the financial services industry about independent investment advice and reduce the relevance of the institute for the market practice. I would therefore *de lege ferenda* suggest to focus particular attention on the question of defining the variety of financial instruments considered as an essential condition for the provision of independent investment advice, question of limited investment advice and further the question of admissibility or inadmissibility of providing independent investment advice by entities, who are according to the Directive limited in relation to the variety of financial instruments considered when providing investment advice.

³¹ As is apparent from the wording of Art. 24 (7) a) MiFID II.

³² See s. 29 and following Act No. 256/2004 Coll., on Capital Market Undertakings, as amended.

³³ See Art. 3 (1) MiFID II.