

White Paper Börse Stuttgart

Retail investors are still systematically excluded from trading simple and easy comprehensible bonds – MiFID II Refit has to deliver on strengthening the retail investor participation in capital markets

The aim of MiFID II/MiFIR, the PRIIP and Prospectus Regulations¹ was to strengthen the regulatory framework in order to increase transparency, to better protect retail investors and to rebuild trust in financial markets after the financial crisis. It was closely connected to the political will to encourage retail investors to engage again in capital markets. However, reality shows a different picture. Almost two years after entering into force the regulations have not delivered on their promises. In December 2019, Börse Stuttgart conducted an update of its analysis from April 2019², which showed that retail investors were not able to trade anymore around 4/5 of corporate bonds listed at Börse Stuttgart. The new analysis revealed that the situation has not improved. There are still around 78% of simple and easy comprehensible bonds that cannot be traded by retail investors, which is manifested in a very low trading volume ever since.

Classic corporate bonds are interest-bearing securities that are issued as debt capital. They usually serve long-term financing, for example, for innovative projects and new manufacturing capacities. A bond gives creditors the right to be repaid the capital they provided at the end of the maturity period along with the interest agreed upon.³ They are therefore relatively easy for investors to comprehend. Compared to equities, corporate bonds issued by the same issuer are considered a less risky form of investment. Bonds are issued publicly by issuers to investors on the primary market. Thereafter, they can be traded on the secondary market once they are listed on a stock exchange.

MiFID II Refit has to deliver on increasing retail investor participation in capital markets

The completion of the Capital Market Union (CMU) is one of the key initiatives of the new European Commission, which took office on 1 December 2019. According to Vice President Valdis Dombrovskis, the responsible

Commissioner for Financial Services, further work has to be done in order for the CMU to develop its full potential. In this context, the participation of retail investors in capital markets needs to be strengthened.⁴ In order to come up with viable policy initiatives, the European Commission mandated the High-Level Forum on Capital Markets Union which identified retail investor participation as one of the outstanding issues that need to be worked upon.⁵

The ongoing work on these issues shows that MiFID II/MiFIR and corresponding legislation has not delivered so far on the CMU's objective to foster retail investments. Börse Stuttgart considers the upcoming MiFID II Refit as an important opportunity for policy makers to address the issues, that hinder retail investors to participate in capital markets. One of the most prominent examples is the tradability of corporate bonds. Excluding retail investors from trading simple and easily comprehensible bonds runs against the objectives of MiFID II and the CMU.

Almost 4/5 of corporate bonds are not tradable for retail investors

The current regulatory framework sets wrong incentives for corporate bond issuers. Provisions designed to improve investor protection had the opposite effects. They beguiled issuers into not issuing a KID, not defining the target market or only a very limited one and denominating bonds in very high amounts above 100.000 EUR. This ultimately leads to retail investors being excluded from trading these products. A first analysis conducted by Börse Stuttgart in April 2019 showed that the combined impact of MiFID II/MiFIR, the PRIIP and Prospectus Regulations is significant. New figures from November 2019 confirm that no improvements are in sight.

From 9.914 (9.268) corporate bonds listed at Börse Stuttgart in November 2019 (March 2019) only 2.183 (2.120) of these bonds can be traded by retail investors through their banks.

¹ Markets in Financial Instruments Directive II (MiFID II)/Markets in Financial Instruments Regulation (MiFIR) in force since 03.01.2018; Packaged Retail and Insurance-based Investment Products Regulation (PRIIP Regulation) since 01.01.2018; new Prospectus Regulation – with few exceptions – since 21.07.2019.

² White Paper Börse Stuttgart, "Tradability of Corporate Bonds" (April 2019), available [link](#).

³ Additional rights can also be defined. For example, a plain vanilla bond grants the creditor fixed interest over the bond period. By contrast, in a variable interest bond (floater), the interest rate over the bond period tracks a reference interest rate such as EURIBOR.

⁴ Remarks of Vice-President Valdis Dombrovskis on "Rebooting the Capital Markets Union", available [link](#).

⁵ High Level Forum on Capital Markets Union, available [link](#).

This impasse is problematic for the following reasons: First, retail investors are not able to efficiently build-up their pension provisions on capital markets. Second, the liquidity in trading on the secondary market is decreased. Third, it runs counter one of the fundamental CMU objectives.

For every PRIIP a KID? Only 4 companies created KIDs

Distributing banks have to provide retail investors with a KID prior to selling them PRIIPs. KIDs should help retail investors – in an easy and comprehensible language – to better understand the basic characteristics and risks of these products. Responsible for providing a KID is the issuer. Almost 50% of corporate bonds are classified as PRIIPs. Börse Stuttgart is concerned about this high number as also simple corporate bonds with make-whole call provisions are included. Unfortunately, only 4 bond-issuers have presented KIDs for in total 14 bonds. With KIDs for seven of its bonds HeidelbergCement AG & Fin.Lux. S.A. is one of the very few positive examples.

MiFID II target market: only professionals and eligible counterparties

New provisions of the MiFID II Product Governance extended the requirements for issuers and distributing banks. One prominent example is the product approval process: Issuers have to define a target market for every product, which includes specific product requirements depending on the investor group. Distributing banks consider the target market with every sale by comparing the target market data with the customer characteristics. At Börse Stuttgart there are currently 302 listed corporate bonds, which are not classified as PRIIPs and with a target market different than retail investor.

High denominations: retail investors are excluded

Every issuer defines the denomination of its bonds. The smaller the denomination, the more retail investors will be able to invest. However, the new Prospectus Regulation maintained the incentive for issuers to issue bonds with a denomination higher than 100.000 EUR. There are 2.285 (2.261) corporate bonds, not classified as PRIIP and with a target market that equals retail investor but with a denomination higher than 100.000 EUR. They are in principle not tradable for retail investors.

Decreasing product diversity for retail investors is problematic – our demands

The decreasing opportunities for retail investors to directly invest in corporate bonds stands in stark contrast to the objectives of the CMU. Instead of strengthening retail investor participation in capital markets, new obstacles were created as highlighted in Börse Stuttgart's analysis on the tradability of corporate bonds for retail investors. Against the background of rising life expectancies and demographic change, the new rules prevent retail investors to use corporate bonds for their portfolio diversification in order to provide for their pensions. Retail investors need to rely on alternative investment products whose performance is highly impacted by charges. ESMA documented recently the significant impact of costs on the final returns for UCITS, retail AIFs and SRPs to detriment the of retail investors.⁶ Hence, savings from retail investors are not efficiently mobilized in financing the overall economy.

The ESAs Joint Committee confirmed already in 2018 that indeed also simple corporate bonds with make-whole provision are usually classified as PRIIP.⁷ Due to the MiFID II target market definition and the high denomination of corporate bonds, the available product spectrum is further reduced. Unfortunately, the European Commission in their response⁸ to the ESAs Joint Committee letter on the PRIIPs Regulation did not follow the ESAs advice to offer detailed public guidance on the scope of the PRIIPs Regulation. On a more positive note, BaFin provided clarifications on the scope of the PRIIP Regulation in their notice⁹ from September 2019. Moreover, the German Finance Ministry highlighted in their assessment on necessary amendments to the MiFID II/MiFIR framework that the PRIIPs Regulation should not apply to plain vanilla bonds, including bonds with a make-whole clause.¹⁰ In the same spirit, the ESAs reiterated their concern in a Supervisory Statement, in which they ask the co-legislators to reflect on the scope of the PRIIPs regulation to address only packaged or wrapped products and not necessarily bonds which are held directly.¹¹

Börse Stuttgart welcomes the positive statements of BaFin, the German Finance Ministry and the ESAs and therefore asks policy makers as well as regulators to carefully consider the concerns raised in this paper for the upcoming MiFID II Refit. Retail investors are an important part of capital markets and should not be excluded from participating in it.

⁶ ESMA Annual Statistical Report on the cost and performance of retail investment products from 10 January 2020, available [link](#).

⁷ Letter of the ESAs Joint Committee from 19 July 2018 to the European Commission, available [link](#).

⁸ European Commission Response to the Letter of the ESAs Joint Committee from 14 May 2019, available [link](#).

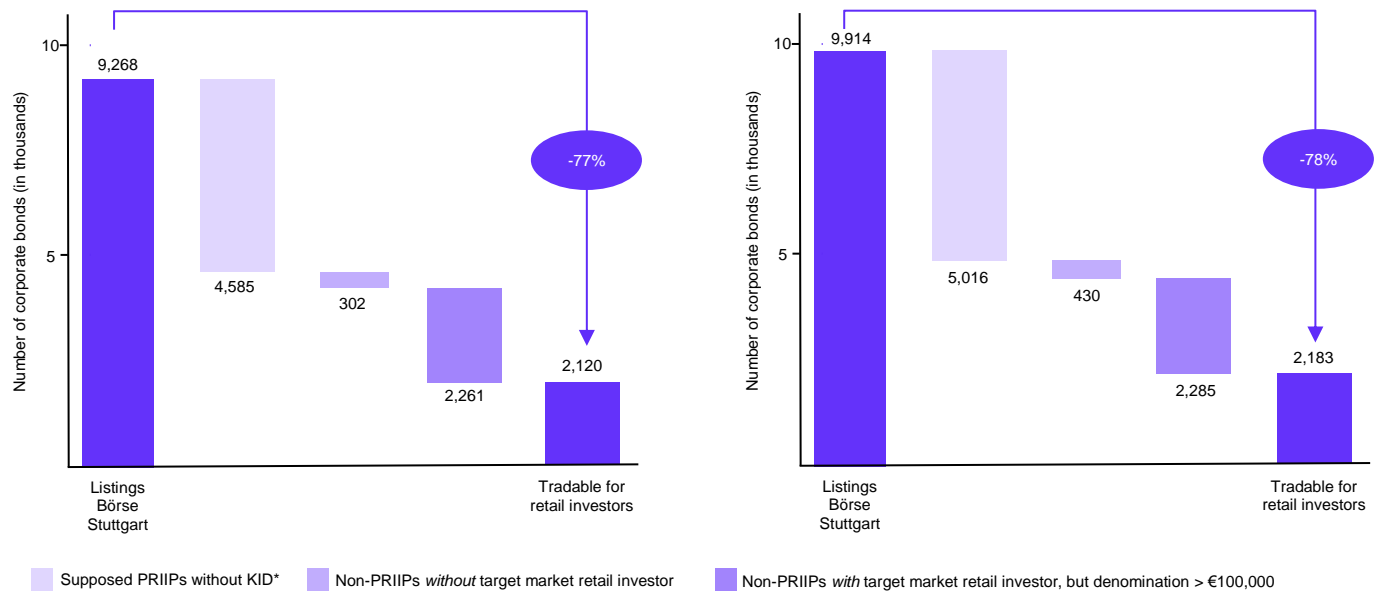
⁹ BaFin Merkblatt: "Aufsichtsrechtliche Einordnung einzelner Ausstattungsmerkmale von Unternehmensanleihen auf Grundlage der PRIIPs-VO", available [link](#).

¹⁰ Position Paper of the German Ministry of Finance on "Necessary amendments and revisions to investor protection provisions in MiFID and PRIIPS", available [link](#).

¹¹ ESA Supervisory Statement on the "application of scope of the PRIIPs Regulation to bonds" from 25 October 2019, available [link](#).

It was a clear objective of the CMU to strengthen retail investor participation – a goal which is strongly supported by Börse Stuttgart. Obstacles in the current legal framework have to be removed.

A situation where retail investors are not able to trade simple and easy comprehensible corporate bonds is not viable.



* Simple corporate bonds falsely classified as PRIIPs, e.g. with a make-whole call provision

Figure 1: Limited Tradability of Corporate Bonds for Retail Investors for March 2019 (left) and November 2019 (right)

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EU Transparency Register No. 31885693900-95
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