THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

CALL FOR EVIDENCE

IMPACT OF THE INDUCEMENTS AND COSTS AND CHARGES DISCLOSURE REQUIREMENTS UNDER MIFID II

RESPONSE FROM THE INVESTMENT ASSOCIATION

6 SEPTEMBER 2019

SUMMARY OF IA RESPONSE

The Investment Association[1] (IA) welcomes the opportunity to respond to the Call for Evidence on the impact of inducements and costs and charges disclosures and the consideration being given to steps to improve the regime. However, it is disappointing to have such a short timeframe in which to respond, especially at a time of year when our member firms are less able to coordinate considered feedback due to the holiday season.

The IA strongly supports the need to provide complete, comparable, consistent and comprehensible information on charges and transaction costs and the comments that follow are made in this context.

Our key comments are:

- The lack of consistency between different cost disclosure regimes, particularly PRIIPs and MiFID II, is an obstacle to clear information for customers. In particular, the complexity and unreliability of the transaction cost methodologies and the use of reduction in yield continue to create significant problems.
- There should be more flexibility to agree with professional clients and eligible counterparties to disapply the MiFID II costs and charges disclosures allowing cost disclosures to be better tailored to clients' needs.
- The frequency of changes to the disclosure regime via Q&As without consultation creates significant implementation issues.

[1] The IA champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage nearly £7.7 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. More information can be viewed on our website.

IA RESPONSE TO THE SPECIFIC QUESTIONS RAISED IN THE CALL FOR EVIDENCE

GENERAL COMMENTS

1.1 The EU network of disclosure frameworks (MiFID, PRIIPs, UCITS, …) continues to be based on the provision by firms of paper/durable media documents to clients in an otherwise increasingly digital world. This ignores the reality that most distribution is intermediated and the distributors that service end clients require data not reports from product manufacturers in order to compile disclosures. This need for data makes it more important than ever that disclosure requirements focus on facilitating accurate and reliable data rather than standardising the format of paper reports across a wide range of products in order to provide superficial comparability.

1.2 We are also concerned about the frequent updating of expectations set out in Q&As which are not consulted upon. This is burdensome to introduce and can create unforeseen issues due to the lack of consultation. We would prefer to see less frequent updates to allow firms to manage the introduction of new requirements and proper consultation to ensure unforeseen consequences are avoided.

MIFID II DISCLOSURE REQUIREMENTS FOR INDUCEMENTS PERMITTED UNDER ARTICLE 24(9) OF MIFID II

A: WHAT ARE THE ISSUES (IF ANY) THAT YOU ARE ENCOUNTERING WHEN APPLYING THE MIFID II DISCLOSURE REQUIREMENTS IN RELATION TO INDUCEMENTS? WHAT WOULD YOU CHANGE AND WHY?

1.3 There is not an equal inducements regime in place for comparable products which means groups now have the ability, depending on their distribution models, to structure their products, or business, in order to avoid the more stringent inducements regime of MiFID II. A UCITS management company or an AIFM in the UK that chooses to distribute its funds using advisers classified as exempt from authorisation as a MiFID firm, rather than a MiFID distributor, will be subjected to a lower level of standards. For example, the rules for a UCITS management company specifically enable the management company to pay for a third party's reasonable travel and accommodation costs when attending educational seminars. These items would not be included within the list of minor non-monetary benefits within the MiFID rules.

1.4 Fixing the UCITS / MiFID divide would not 'fix' the issue as insurance products are also an outlier. We believe therefore that the MiFID rules will only become truly effective when all comparable products are caught by comparable regimes.

QUESTIONS B TO H

1.5 We have no comments on questions B to H.

I: WHAT ARE THE ISSUES THAT YOU ARE ENCOUNTERING WHEN APPLYING THE MIFID II COSTS DISCLOSURE REQUIREMENTS TO PROFESSIONAL CLIENTS AND ELIGIBLE COUNTERPARTIES, IF ANY? PLEASE EXPLAIN WHY. PLEASE DESCRIBE AND EXPLAIN ANY ONE-OFF OR ONGOING COSTS OR BENEFITS.

1.6 Based on feedback from a number of our members, professional clients and eligible counterparties have little interest in either the MiFID II ex-ante or ex-post cost disclosures. They cause a significant cost burden and deliver no discernible benefit.

1.7 One of our larger members told us that the vast majority of their clients ignored the reports and did not find them useful. Their comments reflect views expressed by a number of other members. They said: *"The vast majority of our clients ignored the reports and, of those that did respond, a number of them, especially those based outside the European Union, were confused about their purpose and many asked us whether they constituted invoices. Additionally, some of our clients responded with requests for alternative data to that contained in the reports, which suggests that they intended to use it to populate their own reports for various purposes. Such data includes trade timestamps and a summary of commission data (which clients are already able to access). These responses (as well as the lack thereof) demonstrate that, even where clients know what the reports are, they are not useful to them."*

1.8 Our members are incurring significant costs without any benefit being derived by their professional and eligible counterparty clients. Aside from the one-off cost of delivering the project to produce and distribute the disclosures, there is the ongoing cost of maintaining the systems used to reproduce and aggregate the data for the report, as well as the annual ongoing cost of hiring a team of people to distribute the ex-post report. It is also likely that there will be a significant recurring costs in amending systems to reflect the frequently updated ESMA Q&As.

J: WHAT WOULD YOU CHANGE TO THE COST DISCLOSURE REQUIREMENTS APPLICABLE TO PROFESSIONAL CLIENTS AND ELIGIBLE COUNTERPARTIES? FOR INSTANCE, WOULD YOU ALLOW MORE FLEXIBILITY TO DISAPPLY CERTAIN OF THE COSTS AND CHARGES REQUIREMENTS TO SUCH CATEGORIES OF CLIENTS? WOULD YOU GIVE INVESTMENT FIRMS' CLIENTS THE OPTION TO SWITCH OFF THE COST DISCLOSURE REQUIREMENTS COMPLETELY OR APPLY A DIFFERENT REGIME? WOULD YOU DISTINGUISH BETWEEN PER SE PROFESSIONAL CLIENTS AND THOSE TREATED AS PROFESSIONAL CLIENTS UNDER SECTION II OF ANNEX II OF MIFID II? WOULD YOU RATHER ALIGN THE COSTS AND CHARGES DISCLOSURE REGIME FOR PROFESSIONAL CLIENTS AND ELIGIBLE COUNTERPARTIES TO THE ONE FOR RETAILS? PLEASE GIVE DETAILED ANSWERS.

1.9 The IA strongly supports the need to provide complete, comparable, consistent and comprehensible information on charges and transaction costs. Nevertheless, there should be more flexibility to agree with professional clients and eligible counterparties to disapply the MiFID II costs and charges disclosures, or to limit their scope, regardless of the type of service being provided. Such clients are sophisticated and are already aware of their costs and charges, which are disclosed through the normal course of business (eg. in the invoices which they receive for services provided). Where an explicit figure is not provided (as is occasionally the case when trading on

principal rather than commission), professional clients and eligible counterparties will already have sufficient understanding of the market to be able to ascertain what the cost is (eg. through other market conventions, such as spread).

1.10 Disapplying the costs and charges disclosure requirements for professional clients and eligible counterparties would result in a number of benefits. In particular, eliminating the production of the reports for such clients would mean less waste in the industry, resulting in cost savings which could then be passed on to the end investor.

1.11 There should be no need to distinguish between per se and elective professional clients where the client is party to any agreement to disapply the cost disclosure requirements.

1.12 The nature of professional clients and eligible counterparties, their access to information and their need for legislature to protect their interests is fundamentally different to retail clients and therefore we do not see it as appropriate to align the cost disclosure regimes.

K: DO YOU RELY ON PRIIPS KIDS AND/OR UCITS KIIDS FOR YOUR MIFID II COSTS DISCLOSURES? IF NOT, WHY? DO YOU SEE MORE POSSIBLE SYNERGIES BETWEEN THE MIFID II REGIME AND THE PRIIPS KID AND UCITS KIID REGIMES? PLEASE PROVIDE ANY QUALITATIVE AND/OR QUANTITATIVE INFORMATION YOU MAY HAVE.

1.13 We have observed mixed practices in terms of reliance on the information available in PRIIPs KIDs and UCITS KIIDs. Whilst the rules are framed in terms of permitting investment firms to rely on such information, what really matters is that all information provided to clients should be coherent and consistent. To achieve this, subject to the following comments on each of the KID/KIID regimes, the MiFID II ex ante cost disclosures could be better framed as requiring investment firms to use the information in the relevant KID/KIID.

1.14 The costs disclosed in the UCITS KIID include all costs incurred except for costs explicitly excluded by CESR's guidelines on the methodology for calculation of the ongoing charges figure (OCF). These guidelines have the effect of excluding transaction costs and interest on borrowing from the KIID. UCITS clients would be best served if investment firms use the same one-off charges, ongoing charges and performance fee figures as are given in the KIID, and supplementing these with figures for transaction costs and interest on borrowing supplied by the UCITS management company.

1.15 The costs disclosed in the PRIIPs KID include all costs incurred but are presented in the form of reductions in yield (RIY). Therefore the figures illustrate the compound effect of costs but do not facilitate the aggregation required by MiFID II in order to allow the client to understand the overall cost. Nor do they facilitate the MiFID II illustration of costs showing anticipated spikes and fluctuations. In order to meet their obligations, investment firms need to obtain and use the raw data underpinning the calculation of the RIY figures. This inevitably leads to clients being provided with two sets of conflicting data in relation to a PRIIP. It is essential that this conflict is resolved as part of the PRIIPs review by changing the presentation of cost figures in the PRIIP KID to be actual costs expressed as a percentage of net asset value rather than RIY.

1.16 The PRIIPs methodology for calculating transaction costs is widely interpreted as being incompatible with MiFID II cost disclosures because of the systematic capture of market price movements in the PRIIPs cost calculations. The distortions to transaction cost figures that result has led to many firms using different

methodologies for the calculation under MiFID II and PRIIPs. This leads to clients being provided with two conflicting transaction costs figures. It is essential that this conflict is resolved as part of the PRIIPs review by changing the transaction cost calculation methodology for PRIIPs.

L: IF YOU HAVE EXPERIENCE OF THE MIFID II COSTS DISCLOSURE REQUIREMENTS ACROSS SEVERAL JURISDICTIONS, (E.G. A FIRM OPERATING IN DIFFERENT JURISDICTIONS), DO YOU SEE A DIFFERENCE IN HOW THE COSTS DISCLOSURE REQUIREMENTS ARE APPLIED IN DIFFERENT JURISDICTIONS? IN SUCH CASE, DO YOU SEE SUCH DIFFERENCES AS AN OBSTACLE TO COMPARABILITY BETWEEN PRODUCTS AND FIRMS? PLEASE EXPLAIN YOUR REASONS.

1.17 We are aware of differences in the application of the cost disclosure requirements in different jurisdictions - in many cases these stem from the need to reconcile differences in the detailed regulatory requirements between different legislative packages. The differences between the UCITS KIID and PRIIPs KID requirements are highlighted in our response to question K. Also there are disclosure differences between insurance and non-insurance products.

M: DO YOU THINK THAT MIFID II SHOULD PROVIDE MORE DETAILED RULES GOVERNING THE TIMING, FORMAT AND PRESENTATION OF THE EX-ANTE AND EX-POST DISCLOSURES (INCLUDING THE ILLUSTRATION SHOWING THE CUMULATIVE IMPACT OF COSTS ON RETURN)? PLEASE EXPLAIN WHY. WHAT WOULD YOU CHANGE?

1.18 We do not think more detailed MiFID II rules about the format and presentation of cost disclosures would be helpful. The rules apply to a wide range of products and services and different elements of the disclosures will be more relevant to different products and business models. Forcing such a wide range of products and services into a one-size-fits-all template risks creating something that is not suitable for any given product or service with key information being lost amongst a mass of less critical numbers and blank boxes where there is no relevant data.

1.19 Clients' interests would be best served by improving the coherence of the many legislative regimes that define cost disclosures. In this respect we would be supportive of measures aimed at ensuring consistency of underlying calculation methodologies that sit behind the figures presented whilst leaving firms free to present the figures in the way that is clearest for their product/service and their target market. If the disclosure varies slightly but enables clients to get a good understanding of what is being presented they will be better placed to make comparisons than if they get information that all looks the same but is incomprehensible.

N: FOR EX-ANTE ILLUSTRATIONS OF THE IMPACT OF COSTS ON RETURN, WHICH METHODOLOGY ARE YOU USING TO SIMULATE RETURNS? OR ARE YOU USING ASSUMPTIONS (IF SO, HOW ARE YOU CHOOSING THE RETURN FIGURES DISPLAYED IN THE DISCLOSURES)? DO YOU PROVIDE AN ILLUSTRATION WITHOUT ANY RETURN FIGURE?

1.20 We are aware that a number of approaches are used in practice.

O: FOR EX-POST ILLUSTRATIONS OF THE IMPACT OF COSTS ON RETURN, WHICH METHODOLOGY ARE YOU USING TO CALCULATE RETURNS ON AN EX-POST BASIS (IF YOU ARE MAKING ANY CALCULATIONS)? DO YOU USE ASSUMPTIONS OR DO YOU PROVIDE AN ILLUSTRATION WITHOUT ANY RETURN FIGURE?

1.21 We are aware that a number of approaches are used in practice.

P: DO YOU THINK THAT THE APPLICATION OF THE MIFID II RULES GOVERNING THE TIMING OF THE EX-ANTE COSTS DISCLOSURE REQUIREMENTS SHOULD BE FURTHER CLARIFIED IN RELATION TO TELEPHONE TRADING? WHAT WOULD YOU CHANGE?

1.22 The timing of ex ante cost disclosures takes place with no problems where an investor's journey is online, since providing full costs disclosures online at each step is a straightforward process. But for offline journeys, including but not limited to telephone trading, the story becomes much more complicated. Our members have expressed concern about scenarios involving unsolicited client-led instructions such as the following:

1. Client writes a letter including an unsolicited instruction to buy/sell a particular fund.

2. Client writes an email including an unsolicited instruction to buy/sell a particular fund.

1.23 ESMA says that the requirements are technology neutral, but appear not to have taken account of postal technology. In circumstances such as this, where a firm has not marketed the investment and in effect the instruction arrives out of the blue, in the interests of best execution it is necessary to be able to execute the client's instruction in a timely fashion. The client is not disadvantaged by this having already received a firm-level ex ante disclosure at on-boarding, whilst KIID/KIDs showing the product specific costs are publicly available and will be provided in accordance with the UCITS/PRIIPs requirements. It is not in the client's interest for the firm to prepare and then post a separate total costs disclosure to the client, then wait 48 hours for its presumed arrival (or 24 hours for an email) before executing the client's clear instruction, during which time the share price may have moved substantially from the price at the time of the client's instruction. Our reading of the current rules is that this is not necessary. However, by frequently issuing new Investor Q&As, without any consultation, gives little confidence that ESMA may tip the balance of this interpretation to the detriment of offline clients.

3. Client instructs us over the telephone to buy/sell

1.24 Paragraphs 31 and 32 of the call for evidence refer expressly to telephone trading, which is also a concern where a firm receives unsolicited client instructions. If a client calls a firm at their own initiative to buy a product, giving the firm no time to prepare a bespoke Ex Ante disclosure, it is challenging for the distributor to provide a detailed total costs disclosure, specific to that investment, over the telephone.

1.25 The alternative suggested in paragraph 31 – and in a relevant recent ESMA Investor Protection Q&A – is for the firm to ask the client to defer the transaction until such time as a durable medium disclosure has arrived ('in good time prior'). Again, this means a 24 hour delay for clients with email/online access, or 48 hours for those clients without email or online access – thereby disadvantaging the elderly or those with access issues. It is not clear how this delay in clients' best interests, again given that a firm-level Ex Ante disclosure would have been provided at on-boarding, and

the only element different being the product specific cost (with KID/KIIDs being more easily provided).

1.26 The concern is that ESMA's evolving guidance is moving towards requiring procedures with significant adverse consequences for investors. The risk is that it may effectively kill off postal and telephone orders.

QUESTIONS Q AND R

1.27 We have no comments on questions Q and R.