AFME response to ESMA Call for Evidence: Impact of the inducements and costs and charges disclosure requirements under MiFID II

6th September 2019

About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is registered on the EU Transparency Register, registration number 65110063986-76.

Introductory remarks

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to ESMA's Call for Evidence: Impact of the inducements and costs and charges disclosure requirements under MiFID II.

AFME is strongly in favour of transparency and supports full disclosure of all relevant information about individual contractual and specific commercial relationships between our members and their clients.

AFME's members and their respective clients have reported that the additional disclosure information, which some industry participants have interpreted to be mandated in terms of costs and charges disclosures under MiFID II, is not beneficial to wholesale clients (professional clients and eligible counterparties). Professional clients and eligible counterparties had not, prior to the introduction of the MiFID II costs and charges regime, reported a market failure with respect to commercial disclosures and had not expressed any requirement for a more codified approach to disclosures with respect to their individual commercial relationships with members. Rather, professional clients and eligible counterparties continue to enjoy the highly valued provision of commercial information predating the introduction of MiFID II. AFME members are driven by commercial imperatives to deliver the highest standard of commercial disclosures to their clients. The introduction of the costs and charges regime for professional clients and eligible counterparties under MiFID II does not improve overall levels of information disclosure whilst introducing an unnecessary overhead on producers of the disclosures, both in terms of interpreting the rules and operationalising them. As such, the highly codified costs and charges data regime within MiFID II is extraneous to the needs of professional clients and eligible counterparties. Therefore, AFME supports the disapplication of MiFID II costs and charges disclosures for professional clients and eligible counterparties.

AFME does not support any reduction in transparency. Rather, AFME supports reducing complexity and maintaining the current high levels of transparency through the continued provision of the most fully appropriate commercial information in a format most convenient to the client.

The MiFID II costs and charges disclosure rules do not fully take into account the particularities of the wholesale market. The interpretation of the MiFID II costs and charges rules in relation to our members' business with professional clients and eligible counterparties has and continues to be challenging to interpret as new Level 3 Q&A is published over time.

We believe that the rules should be disapplied for professional clients and eligible counterparties, rather than extending the possibility to clients to opt out. An opt out from the MiFID II costs and charges rules would increase complexity and could be misunderstood by clients as meaning they are opting out of receiving fee schedules, trade confirms or any other pre-existing more detailed reporting that they do value.

AFME would welcome the opportunity to engage with ESMA to discuss the relevant aspects of wholesale markets operation.

AFME responses to Section 4.1 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?***

Some members have encountered issues when making inducements disclosures of exact amounts (within the context of article 11 (5) (b) of the Delegated Directive dated 7.4.2016) when the final exact amount of an inducement changes by immaterial amounts (e.g. because of an extended negotiation period or because it is simply re-adjusted at a later date) multiple inducements disclosures end up being made. Professional clients and eligible counterparties find the receipt of these multiple inducements disclosures which demonstrate immaterial price movements of no benefit and so members would welcome clarification to the effect that there is no need to make multiple inducements disclosures of exact amounts to professional clients and eligible counterparties where immaterial changes are involved.

B. ***Do you use the ex-ante and ex-post costs and charges disclosures as a way to also comply with the inducements disclosure requirements? At which level do you disclose inducements: instrument by instrument, investment service or another level (please specify how)?***

No comment.

C. ***Have you amended your products offer as a result of the new MiFID II disclosure rules on inducements? Please explain.***

No comment.

D. ***Has the disclosure regime on inducements had any role/impact in your decision to provide independent investment advice or not?***

No, it has not.

E. ***How do you apply ex-ante and ex-post disclosures obligations under Article 24 (9) of MiFID II in case of investment services provided on a cross-border basis? Do you encounter any specific difficulty to comply with these requirements in a cross-border context? Please explain.***

No comment.

F. ***If you have experience of the inducement disclosure requirements across several jurisdictions, (e.g. a firm operating in different jurisdictions), do you see a difference in how the disclosure requirements under Article 24(9) of MiFID II and Article 11(5) of the MiFID II Delegated Directive are applied in different jurisdictions?***

Yes. For example, the disclosure requirements in Spain differ from the disclosure in the UK. This is due to the Spanish gold plating of the Quality Enhancement Test (QET) set out in Article 11.2(a) of Commission Delegated Directive (EU) 2017/593 (the "Delegated Directive"), which deletes the reference to "such as".

The position in Spain varies from the position in the UK, where the quality enhancement test is applied to in scope inducements, and individual firms determine whether the service to the client is enhanced by the inducement and are not limited to the examples set out in Article 11.2.(a) of the Delegated Directive as being the only instances where the QET test is met and satisfied.

The Spanish gold plating of Article 11.2.(a) of the Delegated Directive will result in Spanish in scope entities limiting disclosures of inducements, as they will not be permitted to receive or provide inducements where the QET has not been met.

G. ***Would you suggest changes to the disclosure regime on inducements so that investors or potential investors, especially retail ones, are better informed about possible conflicts between their interests and those of their investment service provider due to the MiFID II disclosure requirements in relation to inducements?***

No comment.

H. ***What impact do you consider that the MiFID II disclosure requirements in relation to inducements have had on how investors choose their service provider and/or the investment or ancillary services they use (for instance, between independent investment advice and non independent investment advice)?***

No comment.

<u>AFME responses to Section 4.2 Costs and charges disclosure requirements under Article 24(4) of MiFID II</u>

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.***

AFME recommends that ESMA supports a disapplication of costs and charges disclosures under MiFID II for professional clients and eligible counterparties, because they add no value to these clients. The primary issue members have faced in applying the MiFID II costs and charges requirements is in determining how the rules should be interpreted in relation to their business with professional clients and eligible counterparties. Our members, both individually and in AFME fora, have invested significant resources into making best efforts to determine how the rules and associated Level 3 Q&A should be interpreted to best serve their clients.

The way the MiFID II costs and charges disclosure rules are currently drafted does not fully take into account the particularities of the wholesale market. Thus, members are finding it challenging to interpret costs and

charges rules under MiFID II and resolve when and if to produce any disclosures. The interpretation of the MiFID II costs and charges rules in relation to our members' business with professional clients and eligible counterparties continues to cause challenges in interpretation as new Level 3 Q&A is published over time. AFME would support a pause in publication of further Level 3 Q&A or the exclusion of the wholesale markets (professionals clients and eligible counterparties) from such publications.

The costs and charges rules under MiFID II could be interpreted as requiring additional information to that which was already provided to professional clients and eligible counterparties pre-MiFID II or as mandating a codified format or medium of delivery of information which doesn't appear helpful, and in some cases could be damaging to clients' interests (e.g. in relation to the impact on the timeliness of trades executed by telephone). The usefulness of such additional data and additional or inflexible formatting of the information to be disclosed is not apparent to our members or their professional clients and eligible counterparties. Our members believe that the information with respect to the commercial relationship required and valued by their professional and eligible counterparty clients and the economics of trades they enter into is already transparent (as evidenced by the absence of client demand for additional information). Furthermore, with the exception of information provided to distributors of structured note products, AFME members' professional clients and eligible counterparties have expressed little interest in the additional ex-ante or ex-post cost disclosures that they have provided, having made best efforts to meet the MiFID II costs and charges rules, in line with Level 3 guidance.

Examples of information on commercial relationships which wholesale firms were providing to professional clients and eligible counterparties prior to MiFID II (for commercial, risk management and client service imperatives) include fee schedules, trade confirmations, product specific information, engagement letters, and for certain products and services, detailed daily reporting. None of this useful information, designed based on clients' explicit requirements, would be impacted by the disapplication of the MiFID II costs and charges rules to professional clients and eligible counterparties.

In the infrequent cases where clients do request additional information (which in some members' experience to date has been limited to clients that are distributors of structured products) firms have worked with those clients to produce the information they need in a format which they can reasonably absorb. These types of client requested disclosures for distributed structured products continue to evolve (e.g. through vendor services such as RegXchange) and the structure of the MiFID II costs and charges regimes could hamper this client led development.

A particular issue AFME members have encountered relates to lack of clarity on what should be considered a cost or charge with respect to principal-traded products, which are traded on an "all in risk price". An all in risk price can be described as where a firm takes a risk position and the client does not incur any explicit service charges (such as commission) or embedded product costs (such as distribution or management fees). This has resulted in industry participants adopting a range of approaches and an inconsistency in information provided to professional clients and eligible counterparties. Products such as fixed income and structured products are typically traded with all-in risk price, where a firm trades with a professional client or eligible counterparty on risk (e.g. as a systematic internaliser, market maker or liquidity provider) in a product in which the client has the requisite authority and capacity to trade. Clients understand that that price does not include an explicit transaction cost but reflects the risk price at which the firm is prepared to trade with the client, having taken into account a number of risk factors, including risk of future price movements.

Article 24(4)(c) of MiFID states: "The information about all costs and charges, including costs and charges in connection with the investment service and the financial instrument, which are not caused by the occurrence of underlying market risk, shall be aggregated to allow the client to understand the overall cost as well as the cumulative effect on return of the investment, and where the client so requests, an itemised breakdown shall

be provided." As each broker may take a differing view of the market risk component it follows, therefore, that any attempt to calculate a theoretical value ("a cost" element) embedded in the price but excluding underlying market risk is therefore fundamentally flawed. MiFID II costs and charges rules do not take into account this fundamental characteristic of wholesale markets and therefore attempts to calculate and disclose a theoretical cost add little or no value to clients of those markets (professional clients and eligible counterparties). The underlying principle of the costs rules is to provide clients with transparency on all costs and charges which could impact the performance of their investment in order to aid comparison between service providers and different products. As the all in risk price represents the whole cost to the client, the client has with the price the information they need to compare the prices quoted by a number or firms (and so comply with best execution rules).

While ESMA guidance has indicated that the PRIIPs methodology could be used to calculate implicit costs for packaged products not distributed to retail clients, this guidance does not assist with determining whether or how to calculate a theoretical "cost" for all in risk priced trades (other than those noted above which are distributed, and for which product costs such as distribution fees are included in the price). There are still divergences in how the PRIIPs methodology has been understood and implemented and this inconsistency undermines the policy objective of clients being able to compare different products and services on the basis of associated costs. In any event, we remain of the view that the ability to compare a theoretical "cost" is for professional clients and eligible counterparties neither wanted nor needed as the decision criteria utilised will be the quoted price itself.

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.***

AFME recommends that ESMA supports a disapplication of costs and charges disclosures under MiFID II for professional clients and eligible counterparties, because they are not beneficial to these clients. In AFME's view, costs and charges disclosures as currently set out in MiFID II are not appropriate for professional clients and eligible counterparties for the reasons detailed in Question "I" above and in the Introductory Remarks above. Applying the costs and charges disclosure rules to the fundamentally different product and service model in wholesale markets, where firms may act in a variety of different capacities and transaction scenarios, does not improve overall levels of information disclosure to professional clients and eligible counterparties.

We believe that the rules should be disapplied for professional clients and eligible counterparties, rather than extending the possibility to clients to opt out. An opt out from the MiFID II costs and charges rules would increase complexity and could be misunderstood by clients as meaning they are opting out of receiving fee schedules, trade confirms or any other pre-existing more detailed reporting that they do value, which as described in our answer to Question "I", would not be the case if the rules were instead disapplied. It should be noted that the recommendation is not that any client should receive less than full transparency on a firm's charges. Specifically, it is not recommended that commercial information including fees and charges, which is useful to clients and was already provided to professional and eligible counterparty clients prior to MiFID II or that they reasonably request, be switched off, or not provided. We believe extension of the MiFID II costs and charges rules to professional and eligible counterparty clients has not provided any additional transparency to these clients and that the disapplication of the rules would not be detrimental to legitimate investor protection nor would it reduce transparency to clients on the fees, charges and economics of their trades. We do not believe

that either more flexibility to disapply only certain aspects of the costs and charges requirements or giving professional clients and eligible counterparties the ability to opt out of the cost disclosure requirements completely would address the shortcomings of the regime either as the lack of professional and eligible counterparty client demand for additional, or reformatted, information on costs and charges is not evident.

We note that, for certain products, professional clients and eligible counterparties are also very well informed by their use of vendors who provide Transaction Cost Analysis (TCA being a sophisticated tool) and demonstrates that this client segment is sufficiently proficient at monitoring and understanding costs and charges and have sophisticated options at their disposal to do so.

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.***

No. Generally, AFME members do not use PRIIPS KIDs and/or UCITS KIIDs for their MiFID II costs disclosures. PRIIPs KIDs and UCITS KIIDs are targeted at retail investors and generally AFME members produce, rather than use, the information in the PRIIPS KIDs and/or UCITS KIIDs for their MiFID II costs disclosures.

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.***

No comment.

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?***

AFME does not see a requirement for more rules governing the timing, format and presentation of the ex-ante and ex-post disclosures and would support a pause in the publication of further Level 3 Q&A which do not exclude the wholesale markets (professional clients and eligible counterparties) or the exclusion of the wholesale markets from such publications.

As set out in response to Questions "I" and "J" above, AFME supports the disapplication of the costs and charges disclosure requirements to professional clients and eligible counterparties.

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?***

We do not think it relevant to provide professional clients and eligible counterparties with an illustration of impact of costs on return as this would appear to be a measure more appropriate for less sophisticated clients. Professional clients and eligible counterparties do not need such illustrations in particular for non-complex products. For more complex bespoke products these are usually the result of extensive discussions with the client during which a variety of information and analysis is provided. Professional clients and eligible counterparties are sufficiently sophisticated such that they can understand the data and request additional information they consider necessary to make a decision.

Furthermore, professional clients and eligible counterparties will usually trade with multiple dealers and therefore no single dealer will see their clients entire position/portfolio, thereby making such illustrations meaningless. AFME asserts that clients are receiving more appropriate information on the economics of the trade through existing pre-MiFID II commercial disclosures.

As set out in our answers to Questions "I" and "J" above, we support the disapplication of the costs and charges requirements for professional clients and eligible counterparties.

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?***

Please refer to our answer to Question "N" above.

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?***

AFME proposes a pause in the publication of any further Level 3 Q&A or the exclusion of the wholesale markets (professionals clients and eligible counterparties) from such publications.

As set out in our answers to Questions "I" and "J" above, we support the disapplication of the costs and charges requirements for professional clients and eligible counterparties.

Q. ***Do you think that the application of Article 50(10) of the MiFID II Delegated Regulation (illustration showing the cumulative impact of costs on return) helps clients further understand the overall costs and their effect on the return of their investment? Which format/presentation do you think the most appropriate to foster clients' understanding in this respect (graph/table, period covered by the illustration, assumed return (on an ex-ante basis), others)?***

No comment.

R. ***Are there any other aspects of the MiFID II costs disclosure requirements that you believe would need to be amended or further clarified? How? Please explain why.***

No comment.