

ESMA's Technical Advice to the Commission on the impact of the inducements and costs and charges disclosure requirements under MiFID II. International Bulletin of June 2020.

On 31 March, the European Securities and Markets Authority (ESMA) published a report containing a series of proposals addressed to the European Commission aimed at improving the inducements and costs and charges disclosure requirements under MiFID II. This report includes an analysis of the information collected through a consultation carried out in July 2019 in which the stakeholders (firms subject to this regime and investors) related their experiences in regard to the implementation of the system and the problems detected, while also proposing improvements.

Specifically, in May 2019, the Commission requested ESMA to assess together with the NCAs whether firms comply with inducements and costs disclosure rules in practice, whether the application varies across Member States and, if positive how, as well as assessing the effects of these rules for both professional and retail clients, such assessments to be guided by the broader consideration of the extent to which investors have benefited from the new rules thus far. ESMA was asked to focus on the impact of:

- the requirement to disclose any fees, commissions and non-monetary benefits in connection with the provision of an investment service or an ancillary service to the client in accordance with Article 24(9), including its impact on the proper functioning of the internal market on cross-border investment advice (**inducement disclosures**).
- The requirements of Article 24(4)(c) regarding the provision of investment services and ancillary services (**costs and charges disclosures**).

Inducement disclosure requirements¹

MiFID II strengthens inducement disclosure requirements so that investors are able to clearly understand the impact of inducements on the services they receive. Therefore, unlike MiFID I, the disclosure of inducements may be done in a generic way for minor non-monetary benefits only. All other inducements must be priced and disclosed separately. Further, unlike UCITS or PRIIP rules, payments to distributors which are linked to the sale of a product must be presented as service costs and not included in the total product costs.

However, the information obtained from the consultation seems to indicate that the change in inducement disclosure requirements has not had the expected impact on: 1) the provision of independent advice (clients appear to be unwilling to pay for this type of advice), 2) the products offered as part of the firms' catalogues (due to the uncertainties surrounding the inducement rules and the impact of other MiFID II requirements, such as product governance, catalogues have not undergone many changes), and 3) how investors choose service providers and investment and ancillary services (choices appear to be highly influenced by the client's

personal relationship with the adviser, the perceived quality of the service offered and the perceived diversity of products offered). Therefore, investors still have difficulty understanding the impacts of inducements on the services they receive.

Although some respondents favour a complete ban on inducements for retail products, ESMA is of the view that the Commission should first assess the **impact that the MiFID II inducements regime** has had on the distribution of retail investment products across the Union and to explore **alternative options to improve clients' understanding** of inducements and their impact on the services received by clients. Therefore, ESMA has proposed to European Commission: a) an amendment of the Delegated Regulation to clarify that the ex-ante and ex-post inducements disclosures must always be made on an ISIN-by-ISIN basis thereby showing clients where the firm is most incentivised to recommend and sell a product (i.e., showing clients with what product the firm makes the most money) and b) introducing the obligation to include, in all inducements disclosures, an explanation, in layman's terms, of the terms used to refer to inducements (e.g., third-party payments). The explanation should be clear and simple so that retail clients are able to understand the nature and impact of the inducements. The following language is recommended, "Third-party payments are payments received by [name of the firm or firms (if more than one)] for selling this product to you and are part of the costs that you incur for the service provided by [name of the firm], even though you do not pay such costs directly to [name of the firm]."

To improve understanding of the impacts of inducements on the services received it is also recommended that the European Commission strengthen MiFID II rules in relation to **quality enhancing services**. Article 11(2) of the Delegated Directive specifies the conditions that must be met for the fee, commission or non-monetary benefit to enhance the quality of the service to the client. However, an exhaustive list is not provided, and this has led the various national competent authorities to adopt different approaches. While some have drawn up closed lists, others have provided non-exclusive examples. ESMA believes that the firm should bring to the attention of its clients the specific quality enhancing services that the client is already benefiting from or that the client could benefit from and the list of such quality enhancing services should be easily accessible and updated on a continuous basis. However, despite the problems of convergence, the creation of an exhaustive list that covers all circumstances and features of the different jurisdictions would require a more in-depth study, which is not currently viable.

Going back to the proposal to ban inducements on retail products in the Union, to establish whether this would be an appropriate measure, ESMA believes that the European Commission should first assess, a) the **impact of such a ban** depending on the different distribution models existing in the Union, and, b) what potential additional actions could be taken to **counterbalance the risks of undesired consequences** linked to a ban on inducements. To assess the potential positive or negative effects of a ban, the impact of the bans as introduced in the Netherlands and the United Kingdom should be examined. The Netherlands believes that the ban encourages the distribution of more cost-effective investment products to consumers, reduced conflicts of interest for advisers, while increasing competition between product manufacturers to the benefit of consumers. However, if a Union-wide inducement ban were to be introduced, the impact would likely vary across Member States based on the prevalence of the existing distribution models. In the case of Member States with bank-centric distribution models, there is a risk that banks could react by increasing closed-architecture models to compensate for the loss of inducements. In this way, inducement bans could be circumvented by firms through vertical integration practices between banks and asset managers and only group products might be offered to end-clients. In this case, the management company, instead of paying the bank through a fee rebate, would pay the bank by way of a dividend or a capital reserve. ESMA considers that additional actions would need to be considered to also tackle investor protection issues arising in these types of models, such as strengthening MiFID II requirements on the assessment of suitability to ensure that entities assess their products against third-party products and provide details in the suitability report of any cheaper and less complex alternatives. Another option could be to enhance record keeping on the financial instruments distributed to clients in the

preceding twelve months so that the competent authorities can check whether the entities have complied with their disclosure obligations. A further option would be to consider that the inducement is hidden in the closed architecture and apply the quality enhancement requirements. Lastly, it would be advisable, in the mid- to long-term, to invest in financial education to make retail investors aware and conscious of the importance of independent fee-based advice.

Additionally, banning inducements may create an uneven playing field with other types of products (for instance, insurance products). ESMA would recommend that the impact assessment be carried out and any following actions be taken **in relation to all retail investment products**, not just those regulated by MiFID II.

Lastly, the consultation has revealed differences between Member States in the interpretation of the concept of inducements for payments to entities acting as underwriters or placing agents for issuers. ESMA considers that the regime would be applicable as long as the firm acting as placing agent provides investment services to clients who purchase the products. In the case of firms participating in the underwriting, the regime would apply if the firm also sells these products to its clients. ESMA anticipates that further analysis might be appropriate in this area, although it makes no specific proposals, and suggests that this situation could be analysed in the context of initial public offerings.

Costs and charges disclosure requirements²

ESMA agrees that it is necessary to make the regime applicable to eligible counterparties and professional clients more flexible. Specifically, **eligible counterparties**, on request, should be allowed to opt out completely of the ex-ante and ex-post costs and charges disclosures, subject to the condition that firms shall keep records of the documented opt-out requests. The obligation to provide the illustration of the impact of costs on return should not apply to eligible counterparties, without the need to opt-out. Depending on the service they receive, all **professional clients** should be allowed more flexibility, regardless of whether they are professional clients per se or professional clients on request. Except for portfolio management and investment advice services, which should be subject to general costs disclosure rules, for all other services professional clients should be allowed to opt-out completely of the ex-ante and/or ex-post costs disclosures, including the obligation to provide the illustration of the impact of costs on return. For this purpose, firms shall keep records of the documented opt-out requests and that they contractually agree with their clients, and what type of costs information the client will receive instead.

However, ESMA does not consider that the creation of a new sub-category of sophisticated or experienced retail clients with the option to request to opt out of any requirement of the general regime is needed, as this would add complexity and MiFID II already allows experienced retail clients to apply to be treated as a professional client and, therefore, they could gain access to the proposed more flexible regime for professional clients, as indicated above.

ESMA also believes that the **default costs and charges disclosure regime** (for retail clients, but with the exceptions mentioned above) should not be modified. However, it does suggest the regime should be further clarified to ensure maximum harmonisation and comparability. These improvements would involve:

1) Some of the ESMA Q&As relating to costs and charges disclosure requirements should be incorporated into the MiFID II Delegated Regulation, thus making them binding requirements and reinforcing convergence. These questions and answers refer to a) the level of aggregation for ex-ante disclosures (ESMA's Q&As 9.22 and 9.24 on investor protection), b) the use of tariff grids (ESMA's Q&A 9.23 on investor protection) and c) the level of aggregation for ex-post disclosures for the service of portfolio management (ESMA's Q&As 9.31 on investor protection).

2) In addition, Article 50(9) of the Delegated Regulation should be amended to clarify that:

a) for services other than portfolio management: i) firms should provide clients with ex-post disclosures showing both the total costs and the costs broken down on an ISIN-by-ISIN basis, in each case for each client account, and ii) the itemised breakdown that clients may request in accordance with Article 24(4)(c) of MiFID II should be provided for each ISIN and per type of costs listed in Annex II of the MiFID II Delegated Regulation, and

b) For the service of portfolio management, the client may request a breakdown on an ISIN-by-ISIN basis and/or per type of costs listed in Annex II of the MiFID II Delegated Regulation.

3) The Delegated Regulation should also be amended to clarify that, as firms are required to provide the actual costs incurred by the client in the ex-post costs disclosures, they should keep records of the client's portfolio on a day-to-day basis so that they are in a position to calculate and show the ex-post costs disclosures as accurately as possible.

For other aspects of the disclosure requirements that should be clarified by amendments to the general regime, such as the calculation period or method of how to calculate the ex-ante impact of costs on returns. However, ESMA recommends holding off on any specific amendments to the MiFID II disclosure costs and charges disclosure requirements in these respects until the PRIIPS Review is completed. If any amendments to the disclosure regime for costs and charges is considered, the appropriate consultations should be launched and firms be given sufficient time to implement the changes.

ESMA believes that the **illustration of the cumulative effect of costs on return** may be useful, both on an ex-ante and ex-post basis. ESMA suggests that further details be included in the level 2 requirements since some diversity has been revealed in the approaches applied. However, as it currently does not have enough data to assess which model would be the most effective to draw investors' attention to the impact of costs on return, ESMA is therefore of the view that more time should be allowed for the European Commission to gather further evidence as to existing or possible models and to run consumer testing before making any changes to level 2.

The consultation also highlights the problems faced by firms when providing ex-ante costs disclosures in the case of **telephone trading** and the need to clarify the requirements to comply with this obligation, thereby preventing delays that could harm customers. ESMA recognises the need to align the MiFID II costs and charges disclosure regime with the PRIIPS framework and Directive 2002/65/EC on the distance marketing of consumer financial services, and provide that, where a transaction is carried out by telephone at the request of the client and it is not possible to provide the ex-ante costs disclosure in good time before the transaction, the relevant costs disclosures may be provided immediately after the transaction is concluded.

As already mentioned in relation to the inducements scheme, investment products with the same characteristics should be treated the same. Hence, not only financial instruments, but also similar investment products (in particular, insurance products) should be subject to the costs and charges disclosure regime set forth by MiFID II.

Lastly, ESMA recommends amending Article 3 of the MiFID II Delegated Regulation so that, when information must be provided in a **durable medium**, the provision of such information by means of electronic communications shall become the default option. Only if the client has not given the firm a valid email address or if it explicitly requests the information in paper form, should the firm provide the information on paper. Firms should also be required to provide clear information to their clients on the consequences attached to the provision of a valid email address, and the fact that in such case no information will be provided in a paper form, unless explicitly requested by the client. Further, Articles 66(3) and 47(1) of the Delegated Regulation should also be amended so that firms are not required any more to personally address their best execution and conflicts of interest policies to their clients; provided that such policies are freely accessible on the firm's website.

¹ The main regulatory references in this study, on which proposals are made, are Article 24(9) of MiFID II, Article 11 of Delegated Directive 2017/593 ("Delegated Directive") and Article 66 of Delegated Regulation 2017/565 ("Delegated Regulation").

² The main regulatory references in this study, on which proposals are made, are Article 24(4) of MiFID II, Articles 3, 50 and Annex II of the Delegated Regulation and Q&A items 9.22, 9.23, 9.24, 9.27, 9.28 and 9.31 of the ESMA Question and Answer Document on investor protection.

Useful link:

[Final Report: ESMA's Technical Advice to the European Commission on the impact of the inducement and costs and charges disclosure requirements under MiFID II](#)