Frankfurt am Main,
6 September 2019

BVI's[1] response to the ESMA Call for evidence Impact of the inducements and costs and charges disclosure requirements under MiFID II (ESMA35-43-1905)

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?

From the product provider perspective, we welcome the MiFID II standards on disclosure of inducements. In particular, we support the approach clarified by ESMA in its Q&A 9.7 on MiFID II and MiFIR investor protection and intermediaries topics that commission payments to distributors shall be extracted from the product costs and shown to investors as part of the service costs. This approach to cost disclosures enables investors to better understand the major cost drivers of their investments and hence, helps them to reach informed investment decisions.

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)?

In the German market, it is very common to disclose information on inducements as part of the ex-ante and ex-post cost disclosures. We understand that in the ex-ante context, disclosures are generally made with reference to individual transactions. As regards ex-post disclosures especially in terms of managing securities accounts for clients, no uniform approach exists. However, BaFin requires at least specification of costs at the instrument level (ISIN by ISIN); this generally includes separate disclosures of inducements.

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

Some of our members offer so-called "clean share classes", i.e. share classes not including any commission payments, in order to cater for the needs of portfolio managers and independent advisors. By investing in clean share classes, portfolio managers and independent advisors can avoid the process of repaying commissions to investors and thus, operate in a more efficient way. We have no indication, however, that the product range provided by our members has been amended as a result of MiFID II disclosure rules specifically.

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Fund companies act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's more than 100 members manage assets of some 3 trillion euros for private investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 22% in the EU Germany represents the largest fund market as well as the second fastest growing market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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

N/A

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.

The cross-border provision of MiFID II services by our members generally takes place only in terms of portfolio management, mostly for third party funds. Since inducements are not relevant in this context under MiFID II, we do not have any specific experience in this area.

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?

We have no evidence of significant difference between inducement disclosure requirements across Member States.

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?

Since disclosures on inducements are implemented as part of the general ex-ante/ex-post cost disclosures and fit therein without any particular problems, we do not see any specific need for changes to the disclosure regime.

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 nonindependent investment advice)?

It is very difficult to assess whether disclosure of inducements in particular has had any impact on the investors' choice of the distribution service or an investment channel. We are not aware of any market studies focusing on this aspect. However, we are convinced that the lack of transparency on the monetary incentivisation in the distribution process of competing investment products not subject to MiFID, such as insurance, fixed-term deposits or building society contracts, will negatively affect the competitiveness of securities at the point of sale.

4.2 Costs and charges disclosure requirements under Article 24(4) of MiFID II

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.
The MiFID II disclosures on costs and charges are clearly designed as a meaningful assistance tool for retail clients helping them to reach informed investment decisions. However, they have basically no added value in case of professional clients and eligible counterparties.

In practice, BVI members struggle with the provision of cost information in the context of individual portfolio management. This service is commonly being provided to professional clients or as outsourcing of the portfolio management function by the management company (which under German law, but also in some other Member States, qualifies as individual portfolio management under MiFID II). In the latter case, portfolio management is being provided to a financial market professional which is able to negotiate the conditions of the service on equal terms and thus, generally qualifies as an eligible counterparty. And yet, regardless of the client's status, Article 50(1) of MiFID II Delegated Regulation prohibits any deviations from the cost information standards primarily designed for retail investors in the context of portfolio management and investment advice. This applies to all categories of professional clients, including professional financial market participants such as banks, insurance companies and UCITS or AIF managers. However, these clients are generally aware of the costs or will seek targeted disclosures on specific items. For their accounting or reporting purposes, for example, professional clients need completely different information on specific cost items, which they agree bilaterally with their portfolio manager. In any case, standardised cost information is of no added value for professional clients.

As regards execution services, professional clients (under Annex II MiFID II) (e.g. credit institutions or investment firms) as well as eligible counterparties are particularly interested in a fast execution of their orders – the disclosure of ex-ante costs often results in inacceptable time delays. In addition, recurring orders of the same type are often placed within a short period of time. In these cases, MiFID II requirements can result in the same cost information being delivered over and over again within a short time period. However, Article 50(1) of MiFID II Delegated Regulation allows only for a limited application of the disclosure standards in the context of execution services.

The provision in Article 50(1) should be amended in order (1) to extend the possibility of a limited application of the cost information standards to all services rendered to professional clients and (2) to allow per se professional clients (according to annex II section I of MiFID II) and eligible counterparties to waive altogether specific cost information based on a contractual agreement.

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. The specific disclosure requirements laid down in Article 50 of MiFID II Delegated Regulation and further specified in the ESMA Q&As have been designed with average retail investors in mind. They are not appropriate for professional clients. Professional clients, regardless of whether they are per se professional clients or those treated on request as professional clients, are much better informed about costs associated with investment services. In general, they know exactly what type of financial instrument they are looking for and which investment service they are interested in. In these cases presentation of aggregated costs in a standardised way is of secondary importance. Instead, professional clients often request tailored information for their accounting or regulatory reporting purposes which is being provided on a contractual basis (cf. our response to the previous question).

   From our point of view there are different possibilities to solve the problem respectively make it smaller. First of all the possibility of making different provisions in terms of Article 50 Delegated Regulation 2017/565 (see the previous question) should be revised so that there are no longer restrictions on certain financial services or financial instruments. In addition, at least per se professional clients (according to annex II section I of MiFID II) and eligible counterparties must be able to dispense with cost information in general. A one-time (revocable) declaration should be sufficient.

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   Another possibility could be to change the system in Article 50 from an opt-out to an opt-in as regards professional clients. That means that the professional clients only receive information if they expressly request it.

2. Moreover, providing portfolio management services under delegation to collective investment undertakings such as UCITS or AIF is considered as discretionary portfolio management under MiFID II in some Member States. This applies to Germany, but also to some other jurisdictions like the Netherlands, and goes down to the interpretation provided by the EU Commission in its FAQs to MiFID I. The management company which delegates the portfolio management of UCITS or AIF is classified by law as a professional client. However, under MiFID II, most of the requirements in terms of portfolio management have been developed with a retail-type service in mind. They do not accommodate the adaptations necessary in order to offer practicable, cost-efficient solutions for B2B relationships. Moreover, third-party portfolio managers are always exposed to a conflict of rules because on the one hand, they need to comply with the MiFID II requirements for discretionary portfolio management, but on the other hand, they are contractually obliged to fulfil all standards applicable to UCITS respectively AIF management on the basis of the delegation agreement resulting from strict requirements of the AIFMD and UCITS Directive.

   Against this background, we are of the opinion that the activity of managing investment funds under delegation should be generally exempted from the scope of MiFID II. Such an exemption would reinforce proportionality under the MiFID II regime. It would also be in line with the current limitation

of scope under Article 2(1)(i) MiFID II and could indeed be facilitated by a simple clarification with the following effect:

(i) *collective investment undertakings and pension funds whether coordinated at Union level or not and the depositaries and managers of such undertakings**, including those operating under delegation**;*

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.

To our knowledge, distributors do not rely on either PRIIPs KIDs or UCITS KIIDs for providing cost disclosures according to MiFID II. One of the reasons is certainly that MiFID II requires aggregated cost disclosures which shall be delivered in one single format according to the specifications in the ESMA Q&As. However, even for the purpose of generating MiFID II compliant cost tables, distributors cannot rely on figures displayed in product KIDs. As it stands, the different information documents do not show the same costs for the same financial instrument because of diverging specifications in the EU frameworks. The problems are particularly crucial with regard to the PRIIPs KID which is meant to become the future standard for informing retail investors about investment products:

- Disclosure of product costs: Cost figures in the PRIIPs KID are presented by using the reduction in yield (RIY) methodology which distributes and levels the costs over the recommended holding period. This also applies to one-off costs such as the entry fees for the purchase of fund units. MiFID II, on the other hand, stipulates that investment firms have to show fluctuations and spikes within the framework of ex-ante and ex-post cost information. This means, for example, that an entry fees must be presented in the year in which it is charged; the same applies to other one-off costs such as any redemption fees.

  Therefore the information on product costs in the current PRIIPs KIDs is generally not usable for the generating the aggregated information on cost under MiFID II.

- Calculation of transaction costs: When distributing investment funds, transaction costs must be disclosed both under MiFID II and, as of 2022, in PRIIPs KIDs as an element of product costs. Transaction costs consist of "explicit" costs (such as broker commissions, platform charges, transaction taxes, etc.) and "implicit" costs. Especially in fixed income markets, broker fees are not explicitly charged to clients, but are included in the price margin of either bid or ask price and thus account for implicit costs. This is undisputable in principle, as is the fact that MiFID II and PRIIPs both strive to capture such implicit charges. The MiFID II text provides further indications for the understanding of costs by specifying that "underlying market risks" (i.e. market movements) should not be considered a cost.

  Nonetheless, the approach on how to estimate implicit transaction costs under the PRIIPs framework, the so-called "arrival price" methodology, systematically treats market movement in the price of an asset between the time of order submission and order execution (so-called "slippage") as a cost factor. Such market movement is therefore reflected in the transaction cost calculations and disclosed as cost to investors. Since movement in the price can be either positive or negative, the effect is that the actual identifiable costs of a transaction – the "explicit"

costs – are in each single case distorted and either under- or overestimated in the eventual calculation results. The use of such distorted figures, sometimes discernible as negative transaction costs, entails high liability risks for product providers and distributors.

As it stands, therefore, many fund providers apply a different methodology for calculating transaction costs under MiFID II. This situation is problematic today (since many funds also deliver PRIIPs-compliant transaction cost figures to insurance companies in order to support unit-linked product distribution), but will become unbearable when funds will be regulatory bound to produce PRIIPs KIDs. Against this background, we urge ESMA to support the current initiative for rectifying the transaction cost methodology and eliminating any inconsistencies with the MiFID II requirements in the context of the pending PRIIPs review.

From the investor's point of view, the current inconsistencies in cost disclosures at the point of sale are hardly comprehensible and require a considerable amount of explanation on the part of the distributors. The objective of transparency and investor protection is thus not satisfied. We think that effective harmonisation of cost disclosure standards for all retail investment products, including those not qualifying as financial instruments under MiFID II, should be one of the main goals of the future regulatory initiatives in the area of investor protection. In order to keep implementation efforts and expenditures at a reasonable level, such harmonisation should be enforced comprehensively in the course of one overarching EU initiative. Sufficient time for implementation should be granted.

Another point of concern is the calculation of ongoing costs for real asset funds which is not sufficiently clear either under PRIIPs or under MiFID II. The outstanding issues concern some key elements of the cost structure which may have a significant impact on the overall amount of costs.

These are:

- Operating costs for properties and other real assets: It is unclear whether funds that invest directly in assets such as real estate, infrastructure projects, etc. must also take into account the operating and maintenance costs incurred at the asset level under MiFID II, while in the case of equity funds, for example, the operating costs of stock corporations are clearly not included.

- Interest payments for external financing of the acquisition of real assets: The question also remains as to whether, in the case of external financing, interest payments due on credits should be reported as financing costs under MiFID II even though debt financing costs in relation to real estate or other real assets are inherent to any economically viable investment in these asset classes and by no means specific to the management of investment funds.

In our view, these questions should be clarified in the context of the pending review of the PRIIPs implementing measures. Nonetheless, since their clarification is also of relevance for ensuring consistent and comparable cost disclosures under MiFID II, we urge ESMA to work towards timely solutions in the PRIIPs context and to promote a common understanding of relevant cost elements for both PRIIPs and MiFID II purposes.

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.

To the best of our knowledge, the practical implementation of the rules in the Member States varies widely in some cases, as the requirements leave a relatively wide scope for interpretation. Some aspects of cost disclosures have already been harmonised by clarifications in the ESMA Q&As which by now encompass already 30 statements on the cost and charges topic. Differences in implementation across Member States should not be problematic for retail investors since they do not commonly hold securities accounts in different jurisdictions. However, the current lack of common standards for cost disclosure also leads to divergent approaches at national level which is more of an issue and effectively hinders comparability between investment firms.

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?

We do not see the need for more detailed regulation at Level 2. If divergent practices are identified, alignment should be sought at Level 3, preferably by way of guidelines in order to ensure proper involvement of stakeholders.

Should ESMA consider further clarifications via Q&As, however, we would very much welcome timely implementation of the web based tool for the publication of all questions received by ESMA as foreseen in Article 16b (3) of the new ESMA Regulation in order to ensure transparency of the relevant issues under consideration.

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?

According to our understanding, distributors generally do not use specific return simulations for the purpose of illustrating the impact of costs on performance. Costs are being shown on a year-by-year under the assumption that the performance in each year will cover the costs (meaning that the investment amount remains stable for illustration purposes).

We believe that such assumptions are clear, readily understandable for the client, appropriate for comparison between different services and not deceptive for investors (performance estimates used for the illustrations can be considered as promised return). These assumptions avoid incurring the same critical issues that emerged in the PRIIPs framework with performance scenarios.

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?

Since MiFID II requires annual ex-post cost disclosures, the common understanding among German distributors is that the ex-post illustration of the impact of costs is equal to the aggregated annual costs in percentage and monetary terms. No specific assumptions in terms of performance are needed in this regard.

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?

ESMA has set out how to disclose cost information (in good time) to a client who places an order via telephone in their Q&A 28, Section 9 of “Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics” on 29 May 2019.This clarification is very helpful for the market as uncertainties in interpretation have been removed without undermining the overarching goal of investor protection.

We believe that these latest clarifications allow for developing feasible solutions for ex-ante cost disclosures in the context of telephone orders. For the sake of legal certainty, however, we would ultimately welcome respective adaptations of the Level 2 requirements.

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)?

The challenge with such illustrations is the level of assumptions needed and the impact of such assumptions on the relevance of the ultimate figures for the individual investor. Therefore, we would rather caution ESMA against considering a standardised approach to cost illustrations based on e.g. uniform assumptions in terms of e.g. holding period or growth rate.

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.

N/A