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Building Personal Financial Futures

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Dear Sirs

ESMA CALL FOR EVIDENCE
INDUCEMENTS AND COSTS AND CHARGES DISCLOSURE REQUIREMENTS UNDER MIFID II

PIMFA's responses to the questions raised in Section 4 of the ESMA paper can be found in Appendix 1. In this covering letter:

- we explain why the questions raised in relation to the disclosure of inducements are largely irrelevant for the UK retail-facing firms that make up PIMFA's membership;
- we outline our profound concerns about (a) the opacity and complexity of the MiFID II costs and charges disclosure requirements as they currently apply, (b) the considerable burdens that this has placed upon firms seeking to comply with those requirements and (c) the suggestions made in the Call for Evidence that the deficiencies of the current regime can best be addressed through further, more detailed rules and mandated presentation formats;
- we identify a number of areas of the MiFID II cost disclosure regime that have caused particular difficulties for our members in terms of their interpretation and application. These issues require a proportionate and considered approach from regulators, driven by thorough cost-benefit analysis and clear evidence of likely consumer outcomes.

In our response to ESMA's May 2014 consultation on its Technical Advice to the European Commission, we made clear that – if there was to be any hope of MiFID II being applied consistently across the industry – the regulators would need to provide unambiguous and detailed provisions on which firms could base both systems specifications/development and necessary changes to in-house processes and procedures. The fact that this did not happen has resulted not only in firms incurring huge costs in interpreting and applying regulation but also in their diverting resources away from their most important function, namely the day-to-day servicing of their clients' needs and wishes.

The Personal Investment Management and Financial Advice Association (PIMFA) is the UK's leading trade association for firms that provide investment management and financial advice to everyone from individuals and families to charities, pension funds, trusts and companies.

PIMFA was created in June 2017 as the outcome of the merger between the Association of Professional Financial Advisers (APFA) and the Wealth Management Association (WMA) and represents both full and associate member firms.

PIMFA's mission is to create an optimal operating environment so that our member firms can focus on delivering the best service to their clients, providing responsible stewardship for their long-term savings and investments. We also lead the debate on policy and regulatory recommendations to ensure that the UK remains a global centre of excellence in the investment management and financial advice arena.

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INDUCEMENTS

In the UK, the MiFID II inducement provisions were implemented so as to accommodate obligations introduced by the FCA's Retail Distribution Review (RDR) in 2012. As a result, UK firms are subject to more stringent requirements in relation to inducements than their EU counterparts. Specifically:

- firms providing portfolio management, independent advice and non-independent advice to UK-based retail clients cannot (a) retain for themselves benefits provided by third parties (with the exception of minor non-monetary benefits (MNMBs)) and/or (b) receive third party benefits in order to rebate them to the relevant clients;
- firms providing portfolio management and/or independent advice to non-UK retail clients and/or to professional clients cannot retain for themselves benefits provided by third parties (with the exception of MNMBs). However, they can receive such third party benefits so long as these are rebated to the relevant clients in accordance with specified conditions;
- firms providing other services (i.e. execution-only services or non-independent advice to non-UK retail clients and/or professional clients) can retain benefits provided by third parties so long as they comply with the conditions specified in Article 24(9) of Directive 2014/65/EU. However, in the UK, execution-only firms that are categorised as "platform service providers" are also banned from accepting distribution commissions from product providers.

Given that the business of most PIMFA members is undertaken predominantly with UK-based retail clients, the result of these additional restrictions is that there are very few third party payments for firms to disclose to their clients. The one exception to this is where firms receive "legacy" commission arising from product sales that took place before the RDR took effect in 2012 – however, as time goes on, this is becoming increasingly uncommon. In these residual instances, we understand that any payments receivable are being disclosed to clients via MiFID II costs and charges disclosures as per the investment services/financial instruments/third party payments breakdown mandated by Article 50(2) of EU Delegated Directive 2017/565. The only issue that firms have raised around the disclosure of such "legacy" payments is the difficulty in obtaining accurate information because:

- product providers make commission payments on different bases to different timescales without identifying how the sums paid relate to the holdings of individual clients, requiring receiving firms to undertake complex manual calculations aimed at determining what part of such payments is attributable to each underlying client;
- the assets on which such payments are made are not held in the firm's custody with the result that third party payments are received/paid out by another party (e.g. an overseas custodian), without clearly identifying how such payments should be attributed amongst relevant clients.

So far as MNMBs are concerned, PIMFA members have confirmed that they are fulfilling their ex-ante disclosure obligations by describing such benefits "in a generic way" - as permitted by Article 11(5)(a) of EU Delegated Directive 2017/593 – in their standard terms and conditions.

COSTS AND CHARGES

Paragraph 13 of the Call for Evidence states that "MiFID II clarified, strengthened and expanded the scope of the costs and charges disclosure requirements". While the last of these three claims is certainly true, the experience of PIMFA members does not support the first two.

The costs and charges disclosure regime has been one of the most difficult, time-consuming and expensive aspects of MiFID II for firms to plan for and implement and, so far, there is little evidence that it has been of benefit to clients. The regime was intended to improve disclosure to consumers of the full costs they pay, some of which were previously "hidden" costs that yet had the potential to affect overall returns. Although the annual ex-post disclosure has delivered some limited improvements for consumers, the objective of enhancing comparability between the costs of one firm and another has not been achieved. We believe that the main reason behind these shortcomings is the way relevant legislative requirements and guidance are framed. Specifically:

- Article 50 of EU Delegated Directive 2017/565, unclear in both its overall intent and its underlying details, failed to provide industry with the clarity it needed to ensure full and consistent application of the costs and charges regime;
- while ESMA's Q&A have clarified some issues, they have left others obscure and have, in other instances given rise to further queries and uncertainties. Furthermore, the timing of ESMA's guidance has been problematic. As a result of many of the Q&As being published when firms' implementation plans were already well-advanced or, indeed, after MiFID II took effect, they have had the effect of retrospectively undermining the approaches that firms applied in good faith and at considerable cost – our comment below on the required specificity of ex-ante disclosures is an illustration of this point;
- the implementation of the PRIIPs regime alongside (but not aligned with) MiFID II has resulted in errors and inconsistencies in product data, frustrating firms' efforts to ensure the accuracy of their own disclosures. Furthermore, the application – via ESMA's Q&A – of elements of the PRIIPs regime in a MiFID II context for which they were not designed has caused immense difficulties – our comment below on the calculation and disclosure of implicit transaction costs is an illustration of this point.

Consequently, **we do not believe that ESMA should be considering amendments to level 1 or 2 rules to cover ex-ante disclosures in telephone dealing scenarios (as per paragraph 32), the need for cumulative effect illustrations to be provided in a more standardised format (paragraph 34) or the imposition of more detailed rules to ensure the comparability of ex-post disclosures (paragraph 38).** Firms interpreted, prepared for and implemented the MiFID II requirements in good faith and with little assistance from regulators; they have also spent the last 18 months trying to bed down and explain to their clients regulatory approaches that are often ill-adapted to the nature of their businesses or the needs of those clients. **Given this, if amendments to MiFID II provisions are required, they should not be managed via a quick-turnaround assessment process. Instead, any amendments must be the subject of detailed cost-benefit analysis, wide-ranging consumer testing and meaningful consultation/engagement with industry; they should also be fully informed by firms' practical experiences of attempting to apply the existing provisions and by the wider views of supervisors who are only just beginning to develop an understanding of how different sectors have fared in implementing the requirements. Most importantly, the requirements must focus on producing disclosures that have value for consumers in terms of aiding investment decision-making and enhancing product comparability and that are also clear and readily comprehensible. If clients do not understand the documentation they receive, there is a danger that they will disengage from the investment process, with the result that they either miss out on information they really need to know or they simply choose not to save or invest at all.**

Required specificity of ex-ante disclosures

Paragraph 17 of the Call for Evidence states: "it is now clear that the cost disclosures may not be done in a general way and have to be specific to a transaction". Although ESMA's view may now be clear, this has only been the case since Q22 was published at the end of March 2019, some 15 months after MiFID II came into effect. In stating that "investment firms shall provide ex-ante information on costs and charges in a fully individualized, transaction-based manner", Q22 relies on Article 24(4) of Directive 2014/65/EU and Article 50(2) of EU Delegated Directive 2017/565, neither of which actually provide any clear indication as to the level of detail at which disclosures should be made.

At the time firms were developing the systems and in-house processes needed to implement these requirements, guidance from the regulators as to the expected content, granularity or presentation of disclosures was absent. Consequently – relying on discussions with their peers and trade bodies, taking advice from lawyers and regulatory consultants and, most importantly, focussing on the most effective way of delivering services to clients – many firms came to the conclusion, in good faith, that generic ex-ante disclosures were acceptable. PIMFA itself came to this view and made its interpretation, based on Recitals 69 and 78 of EU Delegated Directive 2017/565, available to its members – please see Appendix 2 for relevant extracts of the PIMFA guidance.

Furthermore, it is clear from the supervisory experience of PIMFA firms that ESMA's view as to the required specificity of ex-ante disclosures is not understood/shared by the FCA. In the course of a review of ex-ante disclosures undertaken earlier this year, the FCA effectively endorsed the position set out in PIMFA's guidance by confirming to firms that are providing generic ex-ante disclosures that they are "complying with the rules". Given that it is unclear what additional benefit is conferred on consumers by interpreting MiFID II in the way Q22 requires, firms are reluctant to devote further time, money and resource to meet regulatory expectations only recently shared with industry.

Given the supervisory position taken by the FCA, the investment that firms have made in their MiFID II compliance to date, firms' ongoing work in bedding down changes to service documentation and processes with their clients and the fact that no clear case has been made regarding the additional benefit to clients of the Q22 approach, PIMFA members currently providing generic ex-ante disclosures are not minded to undertake a wholesale review of their approach. PIMFA intends to await the outcome of the current ESMA assessment and to engage with the FCA on its ongoing supervisory approach in this area before considering whether it should recommend any changes to the way in which its members seek to comply with these provisions. In addition, we believe that – in the context of its current assessment of the impact of the costs and charges regime and with the possibility of further amendments to come – ESMA should consider temporarily suspending the guidance which it has provided by way of Q&As published in the last six months – as well as providing firms with some degree of certainty about the standards required for compliance, this would reduce the potential for unnecessary or inappropriately-targeted investment by firms.

As a final point, we believe that the approach that ESMA has adopted towards ex-ante disclosure makes business undertaken by non-online means (i.e. by telephone and post) much more cumbersome for clients. As we outline in our response to Question P below, the requirements outlined in the first paragraph of ESMA Q&A 28 are far from "technology neutral" in terms of their impact on service delivery standards and the overall client experience.

<u>Calculation and disclosure of implicit transaction costs</u>

For our members, the most problematic element of the costs and charges regime is the calculation/ presentation of implicit transaction costs (ITCs). Because these had not been explicitly identified as costs to be disclosed in the Level 1/Level 2 legislation, firms first became aware of ESMA's expectations when Q&A 12 was published in June 2017, only 6 months head of MiFID II implementation and at a point when most firms' systems development work was already confirmed and underway. Given this, there was never any realistic prospect of the majority of retail-facing firms complying with the Q12 guidance at the point of implementation. As we explain below, not only does PIMFA consider that the timing of ESMA's guidance was problematic, we also have significant reservations about:

(a) the way in which the ITC requirement was applied;
(b) the appropriateness of applying PRIIP requirements to MiFID II business;
(c) the practical difficulties attendant upon calculating/disclosing ITCs in a retail context; and
(d) the likelihood of ITC data being understood by or useful to retail investors.

We are aware that the ITC methodology has been found to give rise to practical challenges even in the context for which it was originally designed and is, consequently, being looked at as part of the preparatory work being undertaken by the ESAs for the European Commission's review of the PRIIPs Regulation. On this basis, **we believe that Q12 (and all references to it) should be withdrawn from the ESMA Q&A with immediate effect and should not be reinstated, either as is or in amended form, until such time as there is some degree of clarity around how such disclosures can be produced in a proportionate way that provides information of relevance to consumers.**

(a) The way in which the ITC requirement was applied

When ESMA published its Final Technical Advice in December 2014, it made clear that "transaction costs" (defined only as "costs incurred in order to acquire and dispose of investments") should be included in costs and charges disclosures to clients but it also acknowledged that "transaction costs which are embedded in the bid-ask spread of the financial instrument are difficult to quantify" and, as a result, indicated that "transaction costs may be estimated on a best effort basis". In the subsequent EU Delegated Regulation 2017/565, although Table 1 of Annex II requires the disclosure of "all costs and charges that are related to transactions performed by the investment firm or other parties", the examples provided do not include ITCs. Consequently, there is no explicit requirement within MiFID legislation for the disclosure of ITCs.

Instead, the regulatory basis for the ITC requirement sits in Q12, Chapter 9 of ESMA's "Q&A on MiFID II and MiFIR investor protection and intermediaries topics". Q12 takes a cost calculation methodology developed specifically for PRIIPs and applies it across segregated client accounts with seemingly no regard for proportionality. In pursuing this course, ESMA took no account of the disciplines to which the issue of "guidelines and recommendations on the application of Union law" are subject under Regulation (EU) No. 1095/2010 (i.e. consultation, impact studies and cost-benefit analysis); it also contradicted its previous suggestion that transaction costs should be estimated on a best efforts basis by stating that, in instances where the full PRIIPs methodology is not used, any alternative approach should identify "the actual transaction costs associated with the transaction". While many firms are now investigating data sources and systems that might enable them to produce the required information, PIMFA members continue to believe that regulators have failed to abide by the disciplines to which such detailed rule-making is legally subject.

(b) The appropriateness of applying PRIIP requirements to MiFID II business

Retail firms do not consider it proportionate for the PRIIPs ITC method – developed specifically to identify slippage costs incurred in the institutional-scale trading undertaken by product managers - to be applied to retail segregated accounts. Sourcing/recording arrival data and calculating per-trade ITCs is much easier for asset managers who, on a daily basis, tend to undertake a limited number of large-scale trades across their fund range than it is for private client fund managers who may execute hundreds (if not thousands) of individual smaller-scale transactions each day. While it "not being easy" is not a valid reason in itself for recommending the removal of the guidance, it is difficult to justify imposing it on firms where the case for its purpose and end-benefit to clients has not been made. See further comments on this in point (d) below.

As one of our members writes:

> "*There has been no consultation on this issue, which appeared for the first time in mid-June 2017 in the ESMA Q&A without any prior warning; nor has a CBA been undertaken on the requirement for firms to conduct implicit cost analysis across e.g. 30,000 client accounts (vs. a mere 30 'client' accounts if you are a PRIIPs fund group managing 30 funds). That number of accounts could well generate 250,000 to 500,000 transactions in a year, many of which would require manual oversight to validate the implicit costs analysis, and for what? From a philosophical perspective, the spread is not a 'charge' as the trading counterparty is not providing a service to the investor; and there is not a snowball's chance that retail investors will understand or be able to interpret whatever information emerges, let alone make use of it since the data does not provide any useful benchmarked comparison for clients (it tells them nothing about execution quality, for example, and can't be used by the client to assess whether they could have achieved better through another firm).*"

(c) The practical difficulties attendant upon calculating/disclosing ITCs in a retail context

Where firms are attempting to calculate ITCs and include them in client costs and charges disclosures, the approaches being taken seem to differ quite considerably from firm to firm, raising questions - once again – about the extent to which clients are able to use such information to compare and make choices between firms. If the range of different approaches being used expands as more firms seek to implement the ITC requirements, the looked-for benefits of consistency and comparability will be yet further undermined. To illustrate, we are aware that:

- some firms are applying the "alternative approach" to segregated portfolios while others have chosen to apply the full PRIIPs methodology, particularly in instances where bespoke portfolios are primarily invested in collectives and where arrival price data consequently needs to be collected/sourced for relatively small numbers of direct investments;
- some firms are applying the alternative bid-ask spread methodology by reference to their core asset allocation models while others are calculating average spreads per asset class by reference to different types of client accounts (e.g. bespoke portfolios, model portfolios, holistic financial planning accounts), subject to various assumptions as regards asset allocation, turnover levels, impact of stamp duty; and
- where in-house models/account types feature a mix of fund and direct holdings, use of the alternative approach is likely to result in transaction cost calculated on inconsistent bases, mixing fund costs calculated on the basis of the full methodology (i.e. PRIIPs KIID or UCITS KIID + EMT) with direct asset costs based on the alternative bid-ask spread approach.

In terms of practicalities:

- concerns have been expressed that – with firms using different data sources, applying different calculation methods, relying on different assumptions and making different ad hoc adjustments for client or service-specific features – ITC information will not only give an impression of consistency and comparability where there is none but will also be open to manipulation.
- in trying to develop their ITC approaches, firms have been applying the PRIIP methodology to specimen portfolios and instruments. They have found that the resulting ITCs, both positive and negative, have the potential to significantly distort the aggregated costs and charges figures presented to clients, so that they end up bearing no relation to what the client actually pays – this impact is particularly marked where portfolios include illiquid assets or those with wide spreads or in scenarios where the impact of a change in price between arrival and execution is magnified by the size of the holding in relation to the overall portfolio.
- firms are querying how ITC data should be taken into account in other elements of their costs and charges calculations. For example, should ITCs be included in the cumulative effect of costs on return, given that the potential losses represented by ITCs will not actually crystallise until such time as an investment is sold? should ITCs be included in firms' performance reporting and how can this be done without double-counting the loss from a spread that then crystallises on a sale?

(d) the likelihood of ITC data being understood by or useful to retail investors

Looking beyond the huge levels of resource that firms will have to commit to produce ITC data, a very significant element of firms' concern focuses on whether that data will be understood by or be useful to retail clients or whether it will instead serve merely to confuse and, potentially, to undermine the value of the already-complex MiFID II costs and charges disclosures.

In terms of practicalities:

- firms do not believe that accounting for the difference between the mid-point of the spread at the time an order is made and the execution price results in a meaningful cost disclosure for retail clients – it is not a true cost that the client is obliged to pay and it not an opportunity cost either since the mid-price is never actually achievable. Furthermore, the disclosure of ITCs does not improve either transparency or comparability for retail clients – contrary to PRIIP scenarios where transaction costs are disclosed publicly via KIDs (or, for UCITS, via the EMT), transaction costs calculated for segregated accounts are individual to each client with the timing of trades and resultant price achieved also individual to each client. Consequently, there is no transparency - the resulting costs are not made public and there is no means for a client to make any comparison of these costs across the market.

- including ITCs in aggregated costs and charges disclosures is likely to result in client confusion – if ITCs are positive, clients will not understand why they are not being required to pay such charges and, if they are negative (as we believe may well be the case for instruments that are infrequently traded or priced or that are traded on a limit order basis), they will not understand why they do not act to reduce the charges they are required to pay. Explaining the concept of "negative costs" to retail clients is extremely difficult – clients quite reasonably assume that anything that looks like a negative or a deduction is something that they will "get back". While most clients are unlikely to pick up on individual cost elements that amount to just a few basis points, the fact that negative transaction costs make no difference to the overall amount they end up paying (i.e. when product and service costs are aggregated) may make some clients question the validity and trustworthiness of the data as a whole. It has also been noted that negative ITCs, when aggregated with invariably positive explicit transaction costs for disclosure purposes, have the effect of masking (rather than clarifying) the real impact of the latter.
- firms have reached no clear conclusions about how ITCs should be presented to clients (i.e. at portfolio, asset class or transaction level) and are similarly unclear about how ITCs can be incorporated into the aggregated costs and charges figure while also making clear to clients that they have no impact on what clients actually end up paying, either to the firm itself or to the providers of products held within their portfolios. It has been suggested that any explanatory text would need to make clear to clients that only the "explicit costs" element is directly relevant to them in terms of actual costs incurred/paid and that the "implicit costs" element is illustrative, reflecting a notional "cost" that arises because trades can only ever be executed at the prevailing bid/offer price and not at the mid-point of the spread at the time the order was placed. We do not believe that the majority of retail clients would be able to understand an explanation of this sort or, therefore, receive any benefit from the disclosure.
- firms are also querying whether and how ITC data should be taken into account in other elements of their cost and charges calculations. Should ITCs be included in the cumulative effect of costs on return, given that the potential losses represented by ITCs will not actually crystallise until such time as an investment is sold? Should ITCs be included in firms' performance reporting and, if so, how can this be done without double-counting the loss from a spread that then crystallises on a sale. See example below:

<u>Example</u>

- Illiquid AIM market share trading at 90-110p
- Buy shares at 110p
  - Implicit cost on a half-spread basis is 10p
- Same day, sell shares at 90p
  - Implicit cost on a half-spread basis is another 10p
- Total loss = 110p-90p = 20p
- Total implicit costs = 10p + 10p = 20p
- Assume no other costs

Does this result in double-counting the performance?

- Gross performance = -20p
- Implicit costs = 20p
- Net performance = -40p?

Clearly, in the above scenario the client has lost 20p, not 40p. Does this mean firms should be ignoring ITCs for performance purposes, or somehow reverse them out?

Conclusion on calculation/disclosure of ITCs

Although PIMFA has spent considerable time with its members trying to identify a proportionate, consistent and cost-effective solution to ITC compliance, our efforts have so far yielded little. **We believe that the application of the PRIIPs ITC methodology to MiFID business undertaken for segregated retail portfolios is fundamentally wrong and that the guidance provided by Q12 of the ESMA Q&A should be re-thought as a matter of urgency. In the meantime, Q12 should cease to have effect – not only will this save clients from overly-complicated and potentially misleading disclosures and spare firms yet further costs in terms of systems development and accessing data sources, it will also give regulators the chance to undertake the thorough analysis, consultation and consumer testing required to produce provisions that actually achieve the objective of clarifying and strengthening costs and charges disclosure.**

If there are any matters covered in this response upon which you would like further information or further feedback from PIMFA members, please do not hesitate to let me know.

Yours sincerely

S.J. McGuffick

Sarah McGuffick
Lead Regulatory Policy Adviser

PIMFA Building Personal Financial Futures

Appendix 1 : PIMFA responses to Section 4 questions

Section 4.1 : Inducements

As per our covering letter, we are not responding to Questions A to H on the basis that they are largely irrelevant to the way in which the MiFID II inducement provisions have been implemented in the UK.

Section 4.2 : Costs and charges

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.

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.

In response to Qs I and J, a large proportion of PIMFA members provide services solely to retail clients. Where our members do act for professional clients, this tends to be only a very small proportion of their business. Consequently, for ease of administration, most (but not all) firms tend to treat their professional clients in the same way as their retail clients in terms of how in-house procedures and the bulk of regulatory protections are applied. However, notwithstanding that most of our members tend to treat their retail and professional clients similarly, PIMFA would not support any changes to MiFID II requirements to make such an alignment mandatory. MiFID II allows clients to be categorised in different ways in recognition of their varying levels of experience, knowledge and expertise – as well as undermining the regulatory structure permitted under Annex II of EU Directive 2014/65, forcibly aligning the treatment of retail and professional clients would reduce the flexibility that firms currently have in terms of managing their business activities to suit specific client bases (and may, as a result, discourage some firms from offering services to professional clients).

Where our members do take advantage of the flexibility permitted under Article 50(1) of EU Delegated Directive 2017/565, they suggest that professional clients – who tend to trade assets that are more difficult to obtain costs and charges data for – would rather trade these assets without data than have their investment offering circumscribed. By and large, firms' conversations with professional clients suggest that the latter are not particularly concerned about costs and charges disclosure and believe that they would benefit from being exempt from the requirements either altogether or to a greater extent than is currently permitted.

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.

In the vast majority of cases, PIMFA firms do not obtain the information they need to produce their costs and charges disclosure directly from PRIIP KIDs/UCITS KIIDs; instead, they rely on aggregated data feeds from third party providers (e.g. Bloomberg, Morningstar), in some cases using more than one provider in order to ensure complete coverage of their investment universe. While data providers may refer to KIDs/KIIDs in compiling their data, their primary resource is the European MiFID Template (EMT) which is being used by European product manufacturers to provide a wide range of data (product features, target market, distribution strategy, costs and charges) in a standardised format.

However, because product manufacturers are updating their EMT regularly while KIDs need only be amended to reflect material changes, discrepancies between EMT and KID data for the same product are common. In addition, differences in the way that third party providers format, compile and aggregate data mean that data provided by a manufacturer in relation to a given product may be presented to the market in a number of different ways. As a result, although data provider feeds cover a very large proportion of the instruments offered by PIMFA member firms, that data cannot necessarily be relied upon as being 100% accurate and firms are, consequently, engaged in ongoing cross-checking and validation exercises.

As well as there being gaps/inconsistencies in coverage, there are also issues about the timeliness and frequency with which product manufacturers update their product cost data and these have a knock-on effect on the accuracy of the information that distributors can include in their own disclosures to clients. For example, if a PIMFA member produces its annual ex-post disclosure as at 31 December on, say, 7 February, it may end up having to use product cost data from a number of months before the "as at" date of its disclosure because this is the latest material produced by the manufacturer. In the absence of any obligation upon product manufacturers as to the frequency with which they must update product cost data made available to distributors, this is another factor that potentially undermines the integrity of the costs and charges information presented to clients.

We have already relayed to the FCA the concerns expressed by PIMFA firms about (a) inconsistencies between the UCITS, PRIIP and MiFID routes to costs and charges calculation and disclosure and (b) the fact that different approaches to presentation across the industry (i.e. across fund managers, platforms and data providers) are undermining both the ability of advisers and clients to compare product costs and their faith in the data provided to them. The first of these issues is also relevant when it comes to the disclosure of "implicit" transaction costs. For UCITS, where firms are obliged to source transaction cost data separately from the charges information provided in the KIID, PIMFA members have noted large variations in the transaction costs being reported by different types of funds. While these may be attributable, in part, to the different investment strategies or trading patterns of such funds, concerns have also been expressed about the fact that implicit costs are being calculated on different bases (i.e. using the opening price on the day of the transaction or the previous day's closing price instead of the true arrival price) and that there is no transparency around the basis that each product manufacturer is using. As a result, distributors have no idea whether, in looking across transaction costs reported by different funds, they are comparing like with like.

It is also worth remembering that there are products for which no KIDs/KIIDs are available (e.g. non-EEA products) and that firms have to employ different processes to obtain cost data for such products, in some cases contacting individual manufacturers and, in others, creating a set of assumptions derived from other similar products to come to a reasonable estimation of costs.

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.

PIMFA firms are predominantly engaged in UK-based business and we have consequently received no feedback on the application of the costs and charges disclosure regime in other jurisdictions.

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?

No, we do not believe that MiFID II should provide more detailed rules governing the timing, format and presentation of these disclosures at the current time. As per the comments on page 3 of our covering letter, we do not believe that such changes, undertaken via the current assessment, would be proportionate or confer additional benefits on consumers. If amendments to the MiFID II costs and charges regime are required, they should be subject to a review process that requires consultation, cost-benefit analysis and consumer testing and that makes full use of industry, consumer and supervisory experience of the operation of the current regime to date. In order to reduce regulatory complexity and to augment consumer understanding, any review should also seek to identify those elements of the regime that have proven to be least beneficial for consumers with a view to their being either removed or significantly simplified.

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?

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?

In response to Qs N and O, PIMFA has found that – in the absence of any indication in either MiFID legislation or guidance as to how the cumulative effect of costs on return should be calculated or presented – firms have inevitably arrived at a variety of approaches. While these may be perfectly reasonable in the context of each firm's own product/ service offering, the fact that they are based on different assumptions and are applied over different periods and at different levels (e.g. by instrument, asset class or portfolio) means that the outputs vary enormously between firms, even in relation to services that are ostensibly similar. Indeed, the range of returns and cumulative impact figures being reported by firms is so wide that many advisers - when recommending the use of investment services to clients – are simply ignoring them as they do not consider that the data provides a reliable basis for comparison. Conversely, concerns have been expressed that, in situations where a retail client "shops around" by obtaining ex-ante costs information from a number of firms, the client may automatically opt for the "cheapest" without understanding that the figures received from different firms are produced on different bases and are consequently in no way comparable. In these circumstances, it is inevitable that some firms will "game the system", making their charges appear as low as possible and misleading consumers in the process.

In calculating cumulative impact of costs on return on an ex-ante basis, firms' practices vary widely -

- some are using a single assumed rate of return while others are presenting a range of scenarios based on different rates;
- some are looking at returns over a year while others work to a longer timeframe, e.g. referencing the firm's strategic investment cycle or the expected holding periods of relevant products;
- some work on a nil return basis; some use actual historic returns; some produce assumed averages based on potential asset class returns or actual returns of similarly-constituted portfolios; others use the assumed rates of return specified in the FCA's product illustration rules;
- some are calculating returns on an individual instrument basis, some on an asset class basis and others by reference to the performance of in-house strategies or model portfolios;
- some are providing illustrations of cumulative impact only for certain types of services, e.g. for managed portfolios but not for individual transactions undertaken on an execution-only basis.

Firms' approaches to calculating the cumulative impact of costs on return on an ex-post basis appear, at first glance, to be more consistent – most firms indicated that they are using annual performance net of costs, adding in fees incurred during the period and then annualising the difference. However:

- discussions with firms indicated different approaches to incorporating the costs of products held within the portfolio, some doing this on a daily basis but most opting for a monthly approach;
- firms also indicated that where a client's account includes a range of instrument types – e.g. securities, funds, derivatives and structured products – there may be different ways of accounting for performance and costs which results in aggregated disclosures making little sense;

- firms agreed that, given that there is no standard methodology for calculating performance across retail investment portfolios, the base against which the cumulative effect of costs is calculated is inevitably variable, undermining the usefulness of cumulative impact adjustments for comparative purposes.

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?

Please see the comments in our covering letter on the required specificity of ex-ante disclosures. One of the main reasons for firms developing a generic approach to ex-ante disclosures (by which we mean disclosures that clearly identify the types and levels of costs to which a client will be subject albeit not on an instrument-specific basis) was that it enables such disclosures to be given to clients “in good time before” the provision of investment/ancillary services. We reasoned that, if ex-ante disclosures were required on a per transaction basis, the combined effect of the “in good time” and “durable medium” conditions in Articles 46(2) and 46(3) of EU Delegated Directive 2017/565 would be to make such disclosures impracticable for client orders accepted by telephone or post. Given that it is generally the aim for regulatory provisions to apply regardless of the medium of communication used, we assumed that this could not be the intended outcome.

In paragraph 31 of the Call for Evidence, ESMA states that it has “already clarified” how ex-ante disclosures can be made in telephone trading scenarios both for instruments with and without product costs. That clarification – via Q28 of the ESMA Q&A – has only been published very recently, some 17 months after MiFID II came into effect and even longer since firms had to finalise the specifications for the systems they were developing to produce the required disclosures. Upgrading systems and client processes at this point to meet these newly-clarified expectations will put firms to considerable expense and, more importantly, is likely to result in negative outcomes for clients who are prevented from trading within their chosen timeframe. **Given this, we do not believe that the application of the MiFID II rules governing the timing of ex-ante costs disclosures for telephone trading should be further clarified – instead, we believe they should be re-considered, taking into account (a) that generic ex-ante disclosures are capable of providing clients with the level of costs and charges information they need to make informed choices and (b) that clients should not be disadvantaged by delays to trade execution to allow for the delivery of a further regulatory disclosure that will not add to their decision-making process.**

In the paragraphs below, we outline the practical impact of the guidance currently set out in Q28 – while it is clear that per-instrument disclosures can be provided in online scenarios, the same is not true where the client’s chosen method of communication is post, email or telephone, particularly in situations where client instructions are unsolicited:

- *Scenario: a client send an unsolicited instruction to buy/sell a specific fund by letter or email*
  Where a firm has not marketed an investment and the instruction effectively arrives “out of the blue”, the firm will need to execute the client’s instruction in a timely manner in order to meet its best execution obligations. The client is not disadvantaged by the firm doing so as he will have already received a firm-level ex-ante disclosure at on-boarding, whilst KIDs/KIIDs showing product-specific costs are publicly available and will be provided in accordance with the relevant product requirements. It is clearly not in the client’s interest for the firm to have to draft and post an instrument-specific ex-ante 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 price of the instrument involved may have moved substantially from the price pertaining at the time of the client’s instruction. Many of our firms, using generic ex-ante disclosures, do not believe that they have to do this and have been confirmed in this view by the outcome of the recent FCA review of ex-ante disclosures mentioned above.

- *Scenario: a client provides an unsolicited instruction to buy/sell a specific fund over the phone*
  If a client calls a firm at his own initiative to buy a product, giving the firm no time to prepare an instrument-specific ex-ante disclosure, we question whether it is practicable for the distributor to provide such a detailed disclosure over the phone in a manner that is likely to be readily comprehensible to a retail client, especially bearing in mind the need to cover service and product costs (generally expressed in both monetary and percentage terms for clarity), any third party payments and the cumulative effect of costs on return. Q28 also seems not to appreciate that, even where such information can be provided in the course of a phone call, it may not be possible to "simultaneously" provide that information in a durable medium. Many PIMFA members' clients do not have access to either the internet or smart phone technology that would enable this. The alternative suggestion made by Q28 is that the client's transaction should be delayed in order to allow the provision of ex-ante information in a durable medium prior to provision of the service – as well as automatically disadvantaging those with email/online access issues and potentially reducing clients' choices about how they undertake their financial activities, Q28 itself acknowledges that "for transactions where time is of the essence, it may not be in the best interest of the client to delay the transaction".

Article 13(3) of Regulation (EU) No 1286/2014 provides an exemption to the general requirement to provide a KID in good time before a retail investor is bound by a PRIIPs contract – it enables a distributor to provide the retail investor with the KID after a transaction has been concluded so long as certain conditions are met. Although we continue to believe that generic ex-ante disclosures are in keeping with MiFID II requirements as expressed at the time of implementation, we see no reason why the provision of ex-ante cost disclosures should not potentially be subject to a similar exemption.

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)?

For the reasons set out in page 3 of our covering letter, we do not believe that ESMA should "reassess the need to require such illustration to be provided in a more standardised format". As per our comments on the variability of firms' methods for calculating performance, it is clear that work to prescribe the content and format of cumulative impact illustrations could not be undertaken as a standalone exercise but would have wider repercussions – consequently, we believe that regulators need to be absolutely certain about the ills they are seeking to address and about the likely costs, benefits and impacts of any measures they might propose.

We have two further points in relation to cumulative impact illustrations:

- ESMA suggests that a more standardised cumulative impact illustration might be needed "to support investors to compare products" – however, while instrument-specific ex-ante disclosures might enable a client to compare two different products offered by the same firm (depending upon how the assumed rates of return are derived), they will do nothing to aide clients in drawing comparisons between the relative performance/cost impacts of different firms. As with implicit transaction costs, the disclosure of cumulative impact does not improve transparency or comparability across service providers for retail clients – a firm's cumulative impact information is calculated for inclusion in client-specific disclosures and, not being made public, there is no means for a client to make any comparison of these costs across the market.
- In relation to ex-post disclosures, PIMFA firms agree that the cumulative impact of costs on return should be shown for the maximum period covered by the disclosure (i.e. 12 months) – as well as being a meaningful period for clients in terms of investment and performance reporting, it also provides a standard timeframe that might potentially serve as a basis for comparison. However, we have heard suggestions that the cumulative impact of costs on return should be calculated not just against the period under review but since MiFID II took effect or, if later, since the firm

first began to provide a service to the client. We believe that this would be unreasonable in terms of the system development that would be required for firms to collate and store the necessary data and believe that it is questionable whether such data would be of value to clients, especially in scenarios where the constituent investments of portfolios may change quite markedly over an extended period.

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.

Our covering letter outlines our views of the required specificity of ex-ante disclosures and on the inappropriate application of the PRIIPS ITC methodology to segregated retail client portfolios.

PIMFA
Building Personal Financial Futures

Appendix 2 : Extracts from PIMFA guidance to members relevant to the required specificity of ex-ante cost and charges disclosures

FCA FINAL HANDBOOK TEXT	PIMFA COMMENTARY
COBS 6.1ZA.14EU 50(8) Where calculating costs and charges on an ex-ante basis, investment firms shall use actually incurred costs as a proxy for the expected costs and charges. Where actual costs are not available, the investment firm shall make reasonable estimations of these costs. Investment firms shall review ex-ante assumptions based on the ex-post experience and shall make adjustment to these assumptions, where necessary.	MiFID Org Regulation: Recital 78: *Ex-ante information about the costs related to the financial instrument or ancillary service can be provided based on an assumed investment amount. However, the costs and charges disclosed should represent the costs the client would actually incur based on that assumed investment amount.* In conjunction with COBS 6.1ZA.2.17G below, we believe that the ability to make "reasonable estimations" "based on an assumed investment amount" (as per Article 50(8) and recital 78) will enable firms to provide all ex-ante costs and charges disclosures (excluding specific product information contained in PRIIPs KIDs and UCITS KIIDs) on a one-off basis at the start of the client relationship. See Section 2, Note 6 for further details.
COBS 6.1ZA.21G(1) A firm need not treat each of several transactions in respect of the same type of financial instrument as a new or different service and so does not need to comply with the disclosure rules in this chapter in relation to each transaction. [*Note: recital 69 to the MiFID Org Regulation*]	This provision mirrors existing COBS 6.1.15G exactly, also paraphrasing recital 69 of the MiFID Org Regulation. In conjunction with recital 78 of the MiFID Org Regulation (see COBS 6.1ZA.2.10 EU 50(8) above), we believe that this provision will enable firms to provide all ex-ante costs and charges disclosures (excluding specific product information contained in PRIIPs KIDs and UCITS KIIDs) on a one-off basis at the start of the client relationship. See Section 2, Note 6 for further details. If this were not the case and ex-ante disclosures were required for each transaction, the combined effect of the "in good time" and "durable medium" conditions in COBS 6.1ZA.2.13 EU 46(2) and 2.15 EU (46(3) above would be to make such disclosures impracticable for client orders accepted by telephone or post. We do not believe that this is the intended outcome.

Applying the costs and charges disclosure provisions to different service offerings
Note 6 In execution-only and advisory dealing scenarios, firms are unlikely to be aware at the start of a client relationship of exactly which types of financial instruments the client is likely to deal in. However, given the combined effect of: (a) Article 50(8) and recital 78 of the MiFID Org Regulation which allows ex-ante information to be provided using a "reasonable estimation" "based on an assumed investment amount", so long as the costs and charges disclosed represent the costs the client would actually incur on that assumed amount; and (b) COBS 6.1ZA.21G(1) which indicates that, having made an initial ex-ante disclosure in relation to a given type of financial instrument, a firm need not make further ex-ante disclosure for subsequent transactions in financial instruments of the same type, firms should be able to provide one-off ex-ante disclosures to clients at the start of execution-only/advisory dealing relationships that cover the entirety of the relevant service offering as long as they: (c) ensure that their up-front ex-ante disclosure covers the entire range of financial instrument types available to the client in the course of the relevant service (see ► below); and (d) comply with COBS 6.1ZA.2.17G(2) by providing "details ….. that differ from those disclosed in respect of a previous transaction" at the time of the relevant transaction. For products, this would involve the provision of the PRIIPs KID or UCITS KIID, as appropriate. ► Construing "type of financial instrument" broadly, a firm's up-front ex-ante disclosure could provide costs and charges information for (1) instruments that have product charges and (2) direct investments with no product charges (e.g. equities and bonds) on the basis of an assumed investment amount. Where relevant, additional illustrations might be needed to reflect: • any variation in how the firm applies its own charges to different instrument types - for example, if a firm applies different scales of brokerage commission/management fees to equity and bond investments, then, rather than providing a single broad illustration for non-product investments as per (2) above, two illustrations would be required in order to show the client the actual amount he would pay if he undertook a transaction in either equities or bonds for the assumed investment amount; • any significant variations between financial instruments of the same type – for example, a firm might need to produce additional illustrations if it varied the application of its own charges for different products (e.g. (i.e. by charging brokerage commission/management fees in respect of third party funds but not for in-house/group funds) or might choose to do so if it wanted to illustrate the overall costs and charges of different types of funds (i.e. active/passive with relatively high/low product costs).