Finance Denmark's response to ESMA's call for evidence on the impact of the inducements and costs and charges disclosure requirements under MiFID II

FINANCE DENMARK

Memo

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Finance Denmark[1] welcomes the opportunity to respond to ESMA's call for evidence on the impact of inducements and cost & charges disclosure requirements under MiFID II. Besides responding to the specific questions in the call for evidence we would also like to make following general comments:

- Focus should be establishing a simpler and more proportionate cost disclosure regime which provides relevant and comparable information that is to the clear benefit of end-clients. Increased harmonisation and supervisory convergence are very important, but this should not lead to more complex and overly detailed rules.

- The call for evidence focuses on the disclosure rules relating to inducements. We would also like to point out that many of the implementation challenges relating to inducements rather relate to other areas of the regime such as divergent legal interpretations by competent authorities regarding the quality enhancement regime, the principle of proportionality and application to primary market transactions. Whilst noting that the mandate to ESMA is restricted to disclosure, we would welcome a more extensive study on the impact of the inducement rules in MiFID II.

- It should be noted that the industry is heavily engaged in self-regulatory work through FinDatEx to create a better and common standard for data exchange related to cost & charges and target market data. One of the consequences of the MiFID II cost & charges regime is that this has become a truly massive data exercise between manufacturers and distributors. Something which we are not certain that the legislators comprehended would happen when they set out the rules. The industry's self-regulatory work will take some time to finalize and implement, and the regulator should be aware of that.

[1] Finance Denmark is a business association for banks, mortgage institutions, asset management, securities trading and investment funds in Denmark. Our members are mortgage institutions, banks, savings banks, cooperative savings banks, Danish branches of foreign banks, asset managers, Danish securities dealers and investment funds.

Questions: 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?

Ex-ante:
When looking at the cost from a retail client perspective it is easier to comprehend that a financial product has a total cost which consist of a number of elements, which is also how the UCITS KIID and PRIIPs KID are designed. When inducements are classified as service costs under MiFID II it creates some inconsistencies between product costs under MiFID II, where inducements are classified as service costs, and the product costs under the UCITS KIID/PRIIP KID, where it is included in the product cost. This is simply illogical for most retail clients, as it does not match the product focus of the KIIDs/KIDs and means inconsistent information for the investor. The inconsistency also creates a problem of which data to use for the inducement disclosure – the rate in the agreement between distributor and manufacturer or the rate on the fund (EMT). In practice the inducements element could be shown as a separate line and displayed as a “thereof inducement” of the total product costs, which then includes the rate in the agreement between manufacturer and distributor and showing the investor the part of the product cost which is de-facto paid and thereby the payment potentially creating a conflict of interest. This would in our opinion help retail clients.

Ex-post:
In relation to the ex post cost statement, it has been a challenge that the inducements are typically paid to the investment firm once per. month or quarter from the product manufacturer. This means that there is a time delay of up to a quarter between the commission being calculated by the manufacturer and deducting the customer's investment and until it is received by the investment firm. This time lag is important for the ex-post reporting period (and thus potentially which ex post report) to which the commission payment in practice relates.
In many situations the distributor and custodian are not the same institution for large/professional clients. In this case the distributor may not know the complete holdings of the client, nor the exact transactions during the period. This makes it next to impossible to calculate the ex post cost figures. We therefore think that there should be an opt out for professional clients.

For investment funds, there is a challenge in regards to the individual client calculation for financial instruments paying an inducement where – which is often the case – inducement is calculated and booked based on principles which are

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retrospective and which is done on the basis of the total assets held by all clients in the specific instrument. In these situations, the individual calculation will be theoretical based on the agreed inducement fee / fee percentage. In short, what is calculated as the inducement cost for the individual client cannot be identified one to one with what is actually received and booked as inducements are not calculated, booked and received on an individual client basis but is calculated, booked and received based on the total AUM designated to the distributor. We suggest that there is an acceptance of calculation of inducements and the disclosure being done based on the agreed inducement fee / fee percentage. It should be noted that the theoretically calculated inducement is the incentivizing amount as this is what the advisor assumes the inducement income will be on the specific client.

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 our experience Danish distributors use the cost and charges disclosure ex-ante and ex-post to disclose inducements. In general, distributors calculate the inducements received on an instrument by instrument basis - both ex ante and ex post, but the ex-post disclosure is also aggregated for all instruments. The information about the inducement payments coincides with the ex-ante and ex-post cost disclosures to clients.

Some distributors may also disclose differently depending on distribution channel and whether the client intends to buy just one instrument or whether we are looking at a client's total portfolio. The main point is that it is important that flexibility is retained so that we can focus disclosure on the client context.

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

No, the disclosure requirements have not given rise to amendments in the products offered. Changes in the products offered are rather made based on the whole MiFID II package. For example, new inducement free share classes have been introduced due to the ban on inducements for portfolio management. Also, the strict interpretation of marketed and offered in the product governance rules regulation has given reason to only provide access to the products where the administrative costs are covered by revenues generated by the product. This leading to a reduced product offering for the clients.

Referring to the massive data exercise as mentioned under "general remarks" – it could potentially at some point come to a position where a product needs to be removed because of lacking data or erroneous data, but to our knowledge that has not happened to any significant extent.

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

No. The disclosure regime has according to our members not played a significant role in deciding whether to provide independent investment advice or not.

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

Cross-border services have not given rise to specific difficulties, and our members typically apply the requirements from a client perspective (e.g. client's base currency is used).

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?

Those our members, who operate in multiple jurisdictions, primarily operate in the Nordics. These members have not encountered differences in the application of the disclosure requirements, but this could change as the rules/interpretations mature. However, we are more concerned with the differences we see in the interpretation of the minimum requirements to quality enhancement when receiving inducements.

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

No, we experience that some clients have an increased interest in inducements and cost and charges, but generally clients are not interested in the specific parts of the cost. They care about the total cost and especially their return after costs.

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

The disclosure obligation on inducements has not in itself had any significance, but the inducement ban in respect of portfolio management and the requirement of proportional quality enhancements have had significant effects on the markets.

In the short term we have noticed an increased awareness among investors, however, not leading to movement of investors. Investors seem much more focused on total costs rather than on the inducement costs and individual components of the total costs as a starting point. The element of inducements is not different in this context.

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.

Basically, all professional clients and eligible counterparties are aware of the precise costs of their decisions. Therefore, the MiFID II rules in the professional market are unnecessary and basically a cost burden with de-facto no benefit to professional clients. Secondly, in some professional markets the speed of a transaction is crucial to the client and the client is really annoyed by the fact that an ex-ante cost disclosure must be presented before the decision to trade can be taken and executed. The best example of this is phone markets on FX derivatives. The MiFID II cost and charges regime is really not fitted to match derivative markets neither by way of process nor content. It seems as if the cost and charges regime and the language and methodology of the investment world and retail world has been pushed down on the professional derivative markets and it does not fit.

Considering the recent ESMA Q&As we see a challenge in providing adequate ex-ante costs and charges information to clients in all instances. The information must describe the specific costs and charges of a specific investment and not just more general information about the costs and charges associated with this investment type. We would suggest to leave more room to agree the level of information with the clients (see also the answer to question J), in particular regarding products that are traded via the telephone or via chat where it is not always practical or in the interest of the client that information shall be provided before entering into the trade. Please also see the answer to question P about telephone trading.

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.

Given the answer to question "I" we would strongly advise to create an opt out possibility for all professional clients and eligible counterparties.

Many professional investors and eligible counterparties find the detailed and complex information on cost & charges in MiFID II burdensome and have expressed a preference to opt out of the rules. We would like flexibility to agree to the level of ex-ante and ex-post costs and charges information with professional clients and eligible counterparties and see no reason why eligible counterparties and professional clients should not be able to agree to a lower level of costs and charges information.

Regarding the annual information about costs and charges we think that there should be an option to agree to a lower level of information for professional clients and eligible counterparties. To this can be added that at present it seems that the industry does not know how to interpret article 50(9) of the delegated regulation 565/2017 about which clients shall receive the annual information and we have experienced very little close to no interest from our professional clients and eligible counterparties in receiving this information.

We are in favour of an opt-out regime for eligible counterparties and a much wider limited application regime for professional clients than what the Delegated

Regulation and the ESMA Q&A provide for today. A limited application regime irrespective of which investment service that is provided.

- A point which seems to be a contradiction in the intersection between MiFID and PRIIPs is that while PRIIPs only covers disclosure to retail clients, it is expected that the PRIIPs principles and methodologies should be transferred into cost disclosures under MiFID and cover professional clients and eligible counterparties.
- Eligible counterparties should have the responsibility to figure out the cost picture on their own, and there should be full flexibility for authorized and supervised investment firms as eligible counterparties to sort out the costs between themselves.

Often professional clients and eligible counterparties will use multiple distributors and sometimes also multiple custodians. The ex-ante and ex-post cost disclosure rules are meant to provide the investor with an overview of total costs connected to a product or a portfolio. Since product and services are often provided by different investment firms, the client never obtains a full overview which renders much of the cost disclosure irrelevant. It should be optional for these clients to switch off the cost disclosure completely. We do not support that clients can switch off individual parts of the disclosures as this would require substantial IT development.

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.

Most of the Danish market do not use PRIIPS and UCITS KIID for the MiFID II product cost disclosure. Instead the EMT is used as a source for the individual investment reports. Distributors might rely to a certain degree to PRIIPs methodologies when calculating cost and charges. However, they do not rely on PRIIPs KIDs and UCITS KIIDs for the actual cost and charges disclosure. As a distributor you must calculate the service costs and thus need to make additions compared to what is in the KIDs/KIIDs.
There are several reasons that PRIIPS KID and UCITS KIID cost information is not used as product cost information in the MiFID II ex-ante cost disclosures. First, it only makes sense conceptually if the product has a linear cost structure. Secondly, MiFID II states that costs should not be caused by occurrence of underlying market risk. We do not see that this is in line with PRIIP transaction cost methodology as it stands in the RTS (arrival price). Thirdly, the EMT templates are

meant to support the MiFID II cost disclosure regime so most of the Danish market use these files.

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.

Our members have not experienced differences in costs disclosure. However, this could very likely be based on lack of market maturity, and we encourage ESMA to pursue harmonized interpretation as it would otherwise give rise to severe difficulties in operating in multiple jurisdictions (e.g. different IT solutions).

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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?

It is a delicate balance between enabling clients to compare service providers and instruments and providing the flexibility to the service provider to ensure that the disclosure is clear and not misleading.

However, we believe more clarity is needed regarding the handling of entry and exit costs. This is particularly the case for financial instruments such as investment funds, which may operate with swing pricing or subscription and redemption fees which are not known until the total net subscription/redemption amount for all subscribers and redeemers is known.

It could be considered whether it would be beneficial for both the industry and regulators to have a joint process of developing and calculating some examples of costs and charges disclosures to increase a uniform interpretation of what to include in the calculations and how to disclose. Not with the purpose of having more regulation but to ensure uniform interpretation.

Template ex-ante and ex-post (investments):
Changes to the format and presentation should be made along with answer to question A on presentation of inducements in the ex-ante cost presentation. Furthermore, the terminology in the reporting template should be made simpler for the retail client to receive information that is understandable and simple. We suggest the following templates – a minimum report for the client that just want the

top line costs and a larger template with details for some client types and available for instance on demand:

Minimum report:	**In [currency]**	**In Pct.**
Servicecosts		
Total servicecost		
Productcosts		
Total productcosts		
heroff payments to third party (inducements)		
Total costs		
Total report:		
Servicecosts	**In [currency]**	**In Pct.**
One-off costs		
On-going costs		
Costs related to transactions		
Incidental costs (ex. Performance fees)		
Other costs		
Produktomkostninger		
One-off costs		
On-going costs		
heroff payments to third party (inducements)		
Costs related to transactions		
Incidental costs (ex. Performance fees)		
Total costs		

Ex-ante

With regards to guidance on the content and how to comply with the regulation on ex-ante costs we still believe that more guidance should be given with respect to methodology.

We think that guidance should make a clear distinction between portfolio management, advice and execution-only trading situations. There should also be a classification on different types of investment service costs and a mapping between type of service cost template fields in the three different standard investment situations (portfolio management, advice and execution-only). We can deliver a framework proposal for such a guideline on request, but the main conclusions are:

Execution-only: Only include service costs that are directly linkable to the transaction and treat other related service costs as individual services (ex-ante reports) (ex. custody fees). Include all product costs.

Advice: Treat advice as a separate service (ex-ante report) and following transactions as execution-only trades (ex-ante reports). All other related services are to be treated as separate services (ex. custody fees).

Portfolio Management: Estimate all cost components in the portfolio agreement. This is a very separate approach where most cost components need to be estimated under many assumptions. (ex. Estimated number of trades)

Without further guidelines on ex-ante cost disclosure the content of the ex-ante reports are likely to differ significantly across Europe and across distributors. Secondly the guidelines should explain how to comply with the rules in the OTC derivative space and the template for OTC derivatives should look very different since terminology in the derivative markets are very different. The current template does not make sense for clients trading OTC derivatives.

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?

Given the loose Q&A guidance on this provision the most common approach for distributors is a statement that the clients return is reduced by X pct. a year due to costs of the investment. Therefore, no return calculation or assumption is needed.

The few distributors that use estimates of expected returns typically use the Danish numbers called "Samfundsforudsætninger" which are also used when providing customers with forecasts for superannuations.

"Samfundsforudsætninger" are a set of return, risk and cost estimates covering 10 defined asset classes. The estimates are provided by an independent advisory board from three international investment banks. The independent council makes a qualitative assessment of the estimates and publishes them for the industry to use aligned return estimates.

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 illustraton without any return figure?

Same as above

P: Do you think that the application of the MiFID II rules governing the timing of the ex-ante costs disclosure requirements should be further clarified in relation to telephone trading? What would you change?

Yes. In order to accommodate client needs and wishes the rules should allow a standardized generic price grid for telephone trading for all client types. Clients trading per telephone wish swift execution and see the recurring cost disclosure as a hassle.

It should be possible to forward the ex-ante cost information if the client accepts it. Time is often an important factor in telephone trading and currently this information requirement is annoying clients more than it benefits them in these types of markets.

This should also apply to other means of electronic communication normally used to enter into transactions such as chat functions.

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The rules on cost & charges in case of distance communication should be the same as for the suitability report and the PRIIPs KID, i.e. that should be possible to deliver the cost & charges disclosure after concluding the trade, if the exception as stated for the suitability report and PRIIPs KID respectively is fulfilled.

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

No, the mere presentation of aggregated costs and charges in amount and percentage suffices. We don't think the illustration helps clients' understanding. It is important to point out that fictitious returns should not be used solely for illustrative reasons. For many retail clients, fictitious returns are disruptive as these returns can neither be promised nor are reasonably likely. It is our position, therefore, that the effect on the return must be communicated without the requirement to disclose an actual return nor fictitious return.

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.

1) If an investment service or financial instrument uses an element of performance fee, this should not be converted into an annual cost figure based on historical returns included in aggregate cost information received by the client. In-

stead, this fee should be disclosed separately. The reason being that historical returns are in no way indicative of future returns, and similarly, historical performance fees are not indicative of future performance fees. For example, after a period of negative returns, a distributor of a financial product would have to inform investors that there is are no expected costs due to performance fees - which is likely incorrectly.

2) There should be guidelines on how the investment firm should behave in the situation where the clients do not want and indeed declines cost information. At present, there is no possibility to deviate from the rules, and this sometimes results in unwanted interactions with clients. An example could be an experienced client who often trades with a specific type of financial instrument. These clients often request for the distributor to stop sending cost information and there is no way of meeting the client's request within the MiFID II framework.

3) The disclosure rules are to uniform as they attempt to cover both ex-ante and ex-post.
As an example, for ex-post a percentage for aggregated costs and charges is confusing and it is very uncertain how to calculate the percentage as the usual client (incl. retail) will experience the value of the investment fluctuating during the year and because the client will buy and sell financial instruments.

Regarding ex-ante disclosure, further clarity is needed in regard to handling entry and exit costs. This is especially the case were the cost is not known beforehand (e.g. funds using swing pricing).

Furthermore, for some derivatives it is not possible to meaningfully calculate a cost percentage on an ex-ante basis, as there is no invested amount.
It should be ensured that the total aggregated costs and charges as defined in MiFID II is the correct cost disclosure and national competent authorities should refrain from developing supplementary cost disclosure figures, including agreement based.

Finally, in order to provide more transparency, greater alignment between disclosure for insurance products and the MiFID II disclosure should be provided.

Question N, Q and R bundled, related to cumulative effects of costs on return illustrations and a question about whether there are aspects of the cost & charges disclosure regime that should be amended

- We would support the deletion of this requirement in the context of the ex-ante cost disclosure or, at least, that it is limited to investment services where the firm has insight into clients' portfolios through the provision of investment advice or portfolio management or insight into clients' holdings due to that the firm and where investments are made in financial instruments with the purpose to generate a performance or return on investment. An illustration of cumulative effects on return is not well suited for products where the purpose is hedging and not trading e.g. FX and interest rate derivatives, since there is no real investment amount but rather only a principal amount which is covered by the transaction in question. The purpose of hedging transactions for example is not to generate a return, and without that feature as an element of the transaction there is no possibility to calculate neither a cost percentage amount nor the effect that costs during the contract's lifetime will have on any type of return. The focus for these products should be transaction amount and potential service-related costs as a cash amount, as the costs for e.g. an interest rate swap are taken out of the market value.

- Furthermore, the actual benefit of this type of illustration can be questioned on the basis of that any performance estimation made ex-ante is likely to deviate from reality, and any calculation or estimation is as good as the next one. Irrespective of which estimated performance number that is used, the effect is that this number will only be reduced with the total costs for the product or portfolio of products in question. In this context it therefore does not really matter whether firms assume a return of 0%, 3% or 5% etc.
- For some services it is very unclear how to calculate the cost as a percentage (%). It does not make sense to calculate the customer's total cost as a percentage of the total "investment amount" on an aggregated level, mixing different types of trades and costs (for example equity, hedging derivatives, etc.). In some situations, there is no investment amount, e.g. in the case of providing investment research or when trading derivatives. Also, it has to be assumed that the idea of calculating a percentage is to be able to show clients how the performance or return of their investments are affected by the costs applied. Trying to calculate a cost percentage for a financial product which is not designed to generate a return quickly becomes a theoretical exercise with no practical value. From a client perspective the detrimental effect of such a calculation is that the overall cost disclosure will show an erroneous picture, since the disclosure will be distorted when mixing assets like equity and investment funds on one hand and derivatives on the other.
- We would support an amendment to the rules which only requires disclosure of costs in percentage format for investments in financial instruments where the purpose is to generate a return on investment. Additionally,

we would favour a separate disclosure containing instruments which do not have an investment purpose.

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