UK FINANCE

MiFID II Retail Costs and Charges: Guideline Q&As

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Introduction

Article 24 of MiFID II sets out requirements for investment firms to disclose appropriate information on all costs and related charges for both investment and ancillary services. Relevant information on costs and charges includes:

i. information relating to both investment and ancillary services;

ii. cost of advice (where relevant);

iii. cost of the financial instrument recommended or marketed to the client;

iv. how the client may pay for it; and

v. any third-party payments.

The costs and charges disclosure must be aggregated and provided ex ante and, where applicable, ex post on a regular (at least annually) basis.

The requirements are further developed in Article 50 of the MiFID II Delegated Regulation which provides, *inter alia*, for limited application to professional clients and eligible counterparties in particular circumstances. ESMA have also provided guidance on disclosure requirements in its Questions and Answers on MiFID II and MiFIR investor protection topics.

MiFID II significantly increases the granularity and complexity of the costs and charges framework. There are a number of implementation questions on issues including ex-ante and ex-post disclosures, illustrations, transaction costs, third party payments, and the application of limited disclosure.

UK Finance, in consultation with its members, has developed guideline Q&As to support firms in their implementation of the MiFID II costs and charges framework. The document provides details of the key relevant regulatory guidance under the relevant Q&As, but users may want to undertake wider reading of the relevant regulations for further information and context. The key references are MiFID II, MiFID II Delegated Regulation, and the ESMA Questions and Answers on MiFID II and MiFIR investor protection topics.

Please note the Q&As have been drafted to be applied to retail clients only (i.e. not wholesale clients).

UK Finance intends to keep these guidelines under review, and to amend them where appropriate (e.g. in the light of regulatory developments or member feedback of their application).

The Q&As are not in any way binding, have not been subject to regulatory approval, and do not give rise to enforceable obligations or duties with regards to how firms should implement any aspect of the MiFID II requirements. All interested parties are welcome to use the contents of the document, but do so entirely at their own risk.

Guideline Q and As

1. Ex Ante Disclosures

Article 24(4)(c) MiFID II Directive: "The information on all costs and associated charges must include information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing any third-party payments."

Article 50(2) MiFID II Delegated Regulation: "For ex-ante and ex-post disclosure of information on costs and charges to clients, investment firms shall aggregate the following:

(a) all costs and associated charges charged by the investment firm or other parties where the client has been directed to such other parties, for the investment services(s) and/or ancillary services provided to the client; and

(b) all costs and associated charges associated with the manufacturing and managing of the financial instruments. Costs referred to in points (a) and (b) are listed in Annex II to this Regulation.

For the purposes of point (a), ... the aggregated costs and charges shall be totalled and expressed both as a cash amount and as a percentage."

Article 50(5) MiFID II Delegated Regulation: *"The obligation to provide in good time a full ex-ante disclosure of information about the aggregated costs and charges related to the financial instrument and to the investment or ancillary service provided shall apply to investment firms in the following situations:*

(a) where the investment firm recommends or markets financial instruments to clients; or

(b) where the investment firm providing any investment services is required to provide clients with a UCITS KIID or PRIIPs KID in relation to the relevant financial instruments, in accordance with relevant Union legislation."

Article 50(7) MiFID II Delegated Regulation: *"Where more than one investment firm provides investment or ancillary services to the client, each investment firm shall provide information about the costs of the investment or ancillary services it provides. An investment firm that recommends or markets to its clients the services provided by another firm, shall aggregate the cost and charges of its services together with the cost and charges of the services provided by the other firm. An investment firm shall take into account the costs and charges associated to the provision of other investment or ancillary services by other firms where it has directed the client to these other firms."*

Article 50(8) MiFID II Delegated Regulation: *"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."*

Article 50(10) MiFID II Delegated Regulation: *"Investment firms shall provide their clients with an illustration showing the cumulative effect of costs on return when providing investment services. Such an illustration shall be provided both on an ex-ante and ex-post basis. Investment firms shall ensure that the illustration meets the following requirements: (a) the illustration shows the effect of the overall costs and charges on the return of the investment; (b) the illustration shows any anticipated spikes or fluctuations in the costs; and (c) the illustration is accompanied by a description of the illustration."*

1.1 How might firms make their ex-ante costs and charges disclosure?

The point in time at which retail clients compare costs is when they are deciding which firm to choose to provide a particular service. It is therefore of greater benefit to retail clients for them to understand and compare the potential impact of costs on their investment amount before agreeing to buy a service from a firm. Such an approach is aligned with other UK measures (e.g. the Retail Distribution Review), where the generic advisor charging model is disclosed upfront to customers so they can compare across advisory firms.

MiFID II requires firms to provide personalised costs and charges disclosure by aggregating and totalling the costs and charges into a single amount (both cash and percentage), and this should still be done before an investment is made/ specific service is provided.

For non-discretionary (e.g. advisory services), it is suggested that alongside generic rate cards, firms could provide a range of personalised ex ante disclosures, using representative examples of transactions across all relevant product types and asset classes. By using this method, costs do not necessarily need to be disclosed for each MiFID II financial instrument, but instead similar buckets of products (e.g. mutual funds) or similar types of products with homogenous costs (e.g. asset classes where costs can be averaged) can be represented by a reasonable average cost. Structured deposits and securities financing transactions (SFTs) should be included in a rates card where relevant.

Neither the rate cards nor the worked examples would need to address every transaction type or be done on a trade-by-trade basis (but this may depend on a firm's business model). Firms will need to take a view based on their product offering and their risk appetite.

In order to be provided upfront at the point in time when a retail client should be comparing costs, the disclosure will vary depending on the nature of the firm. For example:

- advisory firms might provide disclosure at the same time as the advisor charging model is disclosed;
- discretionary / portfolio management firms might provide disclosure at the same time as the IMA is provided (although ex-ante costs and charges may be required to be provided again where there are changes in the service fees; material changes in strategy that require mandate changes; and where top-ups are made to the portfolio (unless through regular contributions));
- product manufacturer firms selling directly to clients might provide disclosure at the onboarding stage; and
- execution-only services provided by investment firms/platforms might provide disclosure at the time of entry into each transaction for PRIIPS/UCITS products.

Generic rate cards will not generally be appropriate for firms selling bespoke products to clients on a one-off basis. In these circumstances, firms may wish to utilise a personalised disclosure.

Costs which are not known in advance (or might materially impact on the speed of execution) should be estimated and included in the disclosure. The inclusion of appropriate qualifying text should ensure that recipients are clear that costs are estimated/approximate, and that they are likely to change at the actual transaction time.

1.2: Does a discretionary manager need to disclose both service and product costs, and if so, how might they provide ex-ante costs and charges disclosure?

There is a lack of clarity whether both service and product costs need to be disclosed by discretionary / portfolio management firms. The reason for this uncertainty is that these types of firms do not typically recommend (as they are not providing advisory services) or market products, and as discretionary/portfolio managers ae not required to pass on a UCITS KIID or PRIIPs KID, all of which are triggers for requiring service and product costs to be disclosed together.

Notwithstanding this uncertainty, to ensure a consistent approach across firms, firms providing discretionary / portfolio management services may wish to disclose both service and product costs. For predictable discretionary services, it will generally be possible for managers to independently estimate likely asset allocation, turnover, product selection and costs, investment amounts, etc.

Firms providing these services could satisfy ex-ante costs and charges disclosure by adopting the same rates card approach as discussed above. The rates card would show the actual product costs or typical product costs for all potential products/product types which could be placed into the portfolio under the investment strategy that the client is considering (as will be set out in the IMA). For UCITS and PRIIPs included in the rates card, firms could either include the product costs or direct the client to the firm's KID/KIID library.

For non-discretionary management services where it is possible to assume portfolio holdings and costs (e.g. where the portfolio is likely to be operated in a similar way to a discretionary portfolio, except that the client will always have 'final say' on executing a transaction), a similar approach may be possible.

1.3 How might firms deal with costs and charges disclosures where they have overall service fees (for example a flat custody fee)?

For firms that operate a flat fee charging model for certain services where the proportion of the fee attributable per instrument/transaction reduces as the collective size/value of the instruments under the service increases, an aggregated trade-by-trade costs disclosure will be difficult as estimating trading volumes is often impossible. Firms could therefore consider disclosing the individual product costs and the overall service fee as separate disaggregated amounts provided firms could satisfy themselves that providing two lines of aggregated amounts allows them to comply with the requirements and where this will be fair, clear and not misleading to clients. Alternatively, firms could include an estimate/approximation of the proportionate element of the overall fee that applies to the service/transaction and include appropriate qualifying text that a proportion of the costs are estimated.

1.4 How might firms deal with a single on-going advisory fee which covers a client's investment in MiFID and non-MiFID products/services?

For firms offering advisory services which are not limited to making personal recommendations in relation to MiFID II financial instruments, firms may wish provide a generic rate card for the MiFID II instruments on which the firm may advise at the same time as the advisory charging model is disclosed. Such disclosure would be accompanied by worked examples. Firms can chose whether to include non-MiFID instruments in the rates card.

In keeping with the spirit of the disclosure requirements, firms could provide additional personalised ex-ante disclosure which includes both service and product costs at the point that the instruments are being recommended under the service.

While the example discussed above is in relation to a holistic advice service, UK Finance is of the view that a similar approach of providing separate disclosures may be appropriate in other circumstances where a MiFID service covering both MiFID financial instruments and non-MiFID financial products is charged to clients as a single fee structure; for example, certain custody arrangements might fall within this scenario.

1.5 What are the timing requirements for making ex-ante disclosures?

Firms may take different views on when disclosures should be provided to clients taking into account the nature of the client, the service to be provided, and the ability to provide reasonable estimates of costs. Disclosure should always be made in good time before the service/transaction. In choosing an approach, firms may wish to take into consideration:

i. the point in time during the client relationship when they would reasonably expect the client to compare costs with other firms. For some firms, this may be at the starting point of the relationship while for others it may be on a transaction-by-transaction basis.

ii. the ability of the firm to provide estimates of costs which will be meaningful to their client, based on the information they hold or are reasonably able to obtain from the client.

iii. whether the use of average costs to represent certain costs is a reasonable approach based on the distribution/variance of those costs.

iv. the requirement to provide the ex-ante disclosure "in good time" (discussed further below).

For portfolio management and certain ongoing advisory services, disclosure should be provided before the service is provided.

For one-off transactional business or one-off advisory services, disclosure should be made 'in good time' prior to entering into the trade / prior to a firm providing the advice.

Where a firm will have an ongoing relationship with a client, but the exact transactions to be undertaken during that relationship (and so the relevant costs) are unknown or difficult to predict, firms may adopt a number of different approaches including:

- the generic rate card plus worked examples as detailed above (disclosed at onboarding);
- the generic rate card plus worked examples that are selected as being most appropriate for the client (disclosed at onboarding);
- more personalised disclosure based on the client's expected transactional business (disclosed at onboarding);
- trade-by-trade disclosure e.g. for instruments where costs tend to vary more considerably trade-by-trade such as OTC derivatives, alternatives (disclosed at point of trade); or
- multiple ex-ante disclosures each covering the different transactions which could occur e.g. instruments which have similar costs such as equities, bonds, FX (disclosed at point of onboarding).

1.6 What does 'in good time' mean?

There are a number of point in time reference points ("Reference Points") against which the 'in good time' test applies. For example, best execution information needs to be provided before an investment occurs, so the Reference Point is an investment occurring; client agreement information needs to be provided before a customer is bound by a service so the Reference Point is a customer being bound by a service, etc. For costs and charges information, it is the requirement that a customer needs to be provided with the information before an investment occurs or a service is provided, which fixes the Reference Point.

MiFID II provides firms with flexibility and the opportunity to apply context to the interpretation of the term 'in good time'. In the context of ex-ante costs and charges disclosure, firms may wish to take into account some of the practical considerations set out below, which could extend or decrease the minimum time period which might be considered to constitute disclosure having been provided 'in good time'.

i. Minimum time period: the minimum time period before the Reference Point occurs is met. This is likely to be based on the method of delivery of the information i.e. if the method of delivery is by post, the minimum time period will be 2 business days before the Reference Point (based on the 'postal acceptance' rule) whereas if the method of delivery is email, the minimum time period might be half an hour before the Reference Point. If the method of delivery is through an online system which the customer is simultaneously accessing, the minimum time period might be seconds before the Reference Point. If the method of delivery is face-to-face, the minimum time period might be as long as it takes the advisor to walk through the information and the customer to have finished asking any questions.

   AND

ii. Reading time period: the minimum time period for the customer to read what has been provided. This will vary depending on the length of what has been sent (i.e. the number of pages) and the format (an online scroll down in comparison to a hardcopy booklet).

   AND

iii. Comprehension time period: a sufficient time period for the customer to understand what has been provided. This will vary depending on the target market and the complexity of what has been provided (i.e. PRIIPs KID on a complex structured product compared to a UCITS KIID; lengthy terms of business compared to a one page costs and charge disclosure).

   PLUS

iv. Tailoring to customer: any additional time

period which is objectively assessed as being needed due to the category of customer. For example, a customer group that is likely to be receiving a new product and/or service with which they are unfamiliar may need more time. A customer group that is not receiving advice may need more time.

LESS

v. Any relevant set off factors: any time that can be reasonably deducted. Such factors include the urgency of a situation or a customer's relevant prior experience with the product/service. For example, a product that requires a decision relatively quickly may impact on the time that is ordinarily given.

2. Ex Post Disclosures

Article 50(9) MiFID II Delegated Regulation: *"Investment firms shall provide annual ex-post information about all costs and charges related to both the financial instrument(s) and investment and ancillary service(s) where they have recommended or marketed the financial instrument(s) or where they have provided the client with the KID/KIID in relation to the financial instrument(s) and they have or have had an ongoing relationship with the client during the year. Such information shall be based on costs incurred and shall be provided on a personalised basis.*

Investment firms may choose to provide such aggregated information on costs and charges of the investment services and the financial instruments together with any existing periodic reporting to clients."

Q4 ESMA Q&A: *"Based on Article 50(9) of the MiFID II Delegated Regulation, firms shall provide information about the total costs and charges on an annual basis. This means that firms should ensure that once a year the client receives an overview of the total costs and charges incurred in the previous year, based on their personal circumstances and actually incurred costs. These costs and charges shall be totalled and expressed both as a cash amount and as a percentage, as is also described in Article 50(2) of the MiFID II Delegated Regulation.*

In addition to the abovementioned obligation, there is room for firms to provide this information more frequently, for instance every time the client receives a (quarterly) report about the investments."

Q21 ESMA Q&A: *"When investment firms are required to provide their clients annual ex-post information about costs and charges based on article 50(9) of the MiFID II Delegated Regulation, ESMA expects firms to provide such information on the basis of a time period that ends at the latest one year (12 months) after the date on which the ongoing relationship has started and that this information should be provided to clients as soon as possible after the above annual anniversary of the relevant service commencing. Where an existing ongoing relationship between a firm and a client ends during 2018, ESMA expects firms to provide information at that period end. Where part of the reporting period would fall under MiFID I and part under MiFID II regime, investment firms may choose to calculate, on a best effort basis, the costs and charges in line with MiFID II requirements for the entire reporting period or provide this first ex-post report with a breakdown of costs for the two periods and a clear explanation of the basis on which costs have been calculated."*

2.1 What is the time period covered in the ex-post costs & charges disclosure?

Although firms are required to provide an ex-post costs & charges disclosure at least annually, there is no requirement for the annual disclosure to cover a calendar year (i.e. 1st January to 31st December). Instead, the disclosure can cover a period of 365 days (366 in a leap year) from any starting point.

2.2 What is the latest time period for firms to provide the first ex-post costs & charges disclosure?

ESMA has set the trigger for the first disclosure to be the date which falls after 3rd January 2018, and is 12 months after an ongoing relationship has begun or its anniversary. UK Finance considers that making a disclosure "as soon as possible" after this trigger date would include making the disclosure to clients with the next regulatory report.

Where firms wish to synchronise their reporting dates for their clients, in order to provide all of their costs and charges disclosures at one time in the year rather than according to the anniversary of each client's relationship commencing with the firm, they may provide an additional annual disclosure to all of their clients on the synchronised reporting date (even where this report will cover a period looking back 12 months and which may cover part of the period already included in the first ex-post disclosure).

For example, where a client relationship began on 1st March 2017, the firm's first annual disclosure would be due as soon as possible after the 31st April 2018 (covering both MiFID I and MiFID II

periods). Where a firm wishes to make their annual disclosures for all of their clients on 1st June, so as to coincide with their other regulatory disclosures e.g. in a client assets statement, in a portfolio management report, etc), they could provide a further annual disclosure of their costs and charges for the period of 2nd June 2017 to 1st June 2018. Although this disclosure would include part of the period previously disclosed to the client through the initial ex-post disclosure, it would still satisfy the requirement for a report to cover the 'previous year', and would then allow the firm to provide their disclosures for this client on or just after 1st June each year.

ESMA has clarified that the obligation to provide information on an annual basis means that disclosure only needs to occur once a year (but that firms can disclose more frequently). These additional disclosures could include further annual reports (as above) or shorter interim reports covering periods which are less than 365 days. The methodology used to calculate the annual disclosures should also be used to calculate any interim disclosure to clients in order to maintain consistency in the reporting.

Even if firms include their ex-post costs & charges disclosures each quarter in a quarterly report, firms will still need to provide an annual report covering a full 365 day period. For firms disclosing each quarter, the time period covered by the costs & charges disclosure can be the time since the previous disclosure (as opposed to looking back to cover a 365 day period on a rolling basis).

Firms can (but do not have to) send the annual ex-post costs & charges disclosure separately from other annual reports that a firm may issue.

Where a service is ended by a client part of the way through the next 365 day period, firms can satisfy their ex-post costs & charges disclosure by providing a disclosure which covers the partial year to the period when the client ended their service.

2.3 How might firms deal with products that were sold to clients before 3 January 2018 in their ex-post costs & charges disclosures?

As noted above, any ex post costs & charges disclosure made in the first year following 3 January 2018 need only comply with MiFID II requirements for the period from 3 January 2018.

Where a firm is providing (or has provided) an ongoing service to a client during the period covered by the ex-post costs & charges disclosure, that ex-post costs & charges disclosure should include, where possible, all product and service costs incurred by the client during that reporting period, including the cost of a product a client continues to hold during the reporting period but which were invested in prior to 3 January 2018. Where a product was invested in before 3 January 2018 and is still on a firm's product range, firms should have access to the product's costs and associated data. Where a product was invested in before 3 January 2018 and is no longer on a firm's product range, firms will not necessarily have access to the product's costs/data. In these circumstances, firms should not have to disclose product costs unless firms are able to otherwise source the information from the manufacturer. However, firms should make it clear to clients which products are considered to be within the scope of the service provided, and so the related cost disclosure.

The ex-post costs & charges disclosure should include all costs that have been incurred/charged to the client in the relevant reporting period, regardless of when the client actually pays the costs. For example, costs invoiced in the reporting period but not paid, or ongoing advisory fees facilitated from a product and particular facilitated payments are yet to be taken. A firm will need to explain where costs have been incurred but not yet collected.

2.4 How should costs incurred in different currencies be treated?

Costs incurred/charged to the client in different currencies have to be converted into the reporting currency for aggregation and reporting purposes. The FX rate used for this conversion needs to be disclosed on both ex-ante and ex-post costs & charges disclosures. The FX spot rate at the time of generating disclosure reports should be used for the aggregation/reporting save where costs in a different currency have already been converted when charged to the client and should therefore be reflected as the amount actually charged to the client in the converted currency.

2.5 What assumptions might be made for ex-post costs & charges disclosures?

Ex-post cost disclosures should always be based on actual costs incurred by the client. There should be no assumptions made for ex-post disclosures save for the forward looking illustrations which are discussed further below.

3. Illustrations

Article 24(4)(c) MiFID II Directive: *"The information on all costs and associated charges must include information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing any third-party payments."*

Article 50(10) MiFID II Delegated Regulation: *"Investment firms shall provide their clients with an illustration showing the cumulative effect of costs on return when providing investment services. Such an illustration shall be provided both on an ex-ante and ex-post basis. Investment firms shall ensure that the illustration meets the following requirements:*

(a) the illustration shows the effect of the overall costs and charges on the return of the investment;

(b) the illustration shows any anticipated spikes or fluctuations in the costs; and

(c) the illustration is accompanied by a description of the illustration."

Q12 ESMA Q&A: *"This question relates to costs involved when an investment firm buys or sells (or engages in any other transaction in) a financial instrument for its client. These transaction costs are different from the transaction costs incurred by a financial instrument's manufacturer which result from an investment decision (for example a manager changes his fund's asset allocation), and which should be incorporated in the costs of the financial instrument.*

The requirements on total costs and charges require investment firms to incorporate both implicit as well as explicit transaction costs. For retail products, the PRIIPs RTS provides for a detailed calculation methodology for different financial instruments, which ensures that both explicit and implicit transaction costs are captured. Therefore, in that case, for the calculation of transaction costs on an ex-post basis, ESMA would expect the investment firm to use the methodology as covered in paragraphs 12 to 20 (and possibly other relevant paragraphs) of Annex VI of the PRIIPs RTS.

An investment firm may assess that the costs involved in calculating the transaction costs using the method provided in paragraphs 12 to 20 of Annex VI of the PRIIPs RTS are disproportionate compared to their significance. In such cases, the firm may use an alternative approach (for example the method provided for in paragraphs 21 to 23 of the Annex VI of the PRIIPs RTS) to calculate transaction costs, provided that it identifies the actual transaction costs associated with the transaction, and that it clearly discloses to clients the basis on which transaction costs have been calculated."

3.1 How might illustrations of the cumulative effect of costs on the investment be calculated in ex-ante costs & charges disclosures?

Firms might consider differentiating between products with a fixed maturity and open-ended strategies. For products with a fixed maturity, the cumulative effects should be shown covering the time period until maturity of the product. For open-ended strategies (like discretionary portfolios) there could be an assumption for a reasonable period to be assessed (in particular if there are higher upfront / year one costs). For these strategies, the illustrations of the compound effects of costs reducing returns might also be a more relevant illustration than assuming varying gross returns.

Firms will need to estimate the net return (i.e. including costs), and use reasonable assumptions to estimate the actual gross return (i.e. excluding costs).

3.2 How might illustrations of the cumulative effect of costs on the investment be calculated in ex-post costs & charges disclosures?

Firms should provide the actual net return (i.e. including costs) and then use reasonable assumptions to calculate the actual gross return (i.e. excluding costs). It is appropriate for this calculation to be a fairly simple arithmetic calculation (net performance + costs = gross performance) where the costs figure should be the aggregated figure separately provided in

the disclosure and would not need to take into account the timing of charges during the period in question or the compounding of costs over time.

The net performance figure could be calculated using methodologies already used by firms to calculate net performance.

3.3 How might illustrations of the cumulative effect of costs on the investment be displayed?

In selecting the most appropriate illustration(s), firms should bear in mind the primary aim of the disclosure is to be fair, clear and not misleading.

Firms should consider being consistent between the method of illustration chosen for the ex-ante disclosure and for the ex-post disclosure.

Firms could consider providing illustrations of costs covering various possible performance scenarios such as negative, flat and positive. Where a firm's disclosure relates to a PRIIP, firms could consider using the same performance scenarios as are included in the KID.

In relation to the description that must accompany the illustration, this should be written in "plain English".

4. Transaction Costs

Article 24(4)(c) MiFID II Directive: "The information on all costs and associated charges must include information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing any third-party payments."

Article 50(4) MiFID II Delegated Regulation: "In relation to the disclosure of product costs and charges that are not included in the UCITS KIID, the investment firms shall calculate and disclose these costs, for example, by liaising with UCITS management companies to obtain the relevant information."

Q6 ESMA Q&A: "The PRIIPs calculation methodology is designed in such a way that it will capture all costs and charges incurred by a PRIIP. These costs relate to (i) one-off costs; (ii) ongoing costs, which include transaction costs incurred when trading and (iii) incidental costs, such as performance fees. With regard to transaction costs, the PRIIPs RTS provides for a detailed calculation methodology which ensures that both explicit and implicit transaction costs are captured. This would mean that PRIIPs manufacturers can provide all relevant information on an instrument's cost components."

Q8 ESMA Q&A: "PRIIPs defines a 'packaged retail investment product' in Article 4(1). Some financial instruments may be out of the scope of PRIIPs because (1) they are not packaged products; or (2) they are packaged products, but they are not sold to retail investors. Examples of (1) are corporate shares or sovereign bonds. An example of (2) might be an alternative investment fund that is only available for sale to professional clients.

For financial instruments in category (1) above, it would be reasonable to conclude that the PRIIPs cost methodology would not apply. For financial instruments in category (2) above, the methodology described in Annex VI of the PRIIPs RTS appears relevant and investment firms would be expected to use it to calculate the financial instrument's costs. ESMA notes that the calculation of costs, for instance with regard to using simulated or historical data, would be expected to be performed in line with the requirements set out in PRIIPs."

Q12 ESMA Q&A: "This question relates to costs involved when an investment firm buys or sells (or engages in any other transaction in) a financial instrument for its client. These transaction costs are different from the transaction costs incurred by a financial instrument's manufacturer which result from an investment decision (for example a manager changes his fund's asset allocation), and which should be incorporated in the costs of the financial instrument.

The requirements on total costs and charges require investment firms to incorporate both implicit as well as explicit transaction costs. For retail products, the PRIIPs RTS provides for a detailed calculation methodology for different financial instruments, which ensures that both explicit and implicit transaction costs are captured. Therefore, in that case, for the calculation of transaction costs on an ex-post basis, ESMA would expect the investment firm to use the methodology as covered in paragraphs 12 to 20 (and possibly other relevant paragraphs) of Annex VI of the PRIIPs RTS.

An investment firm may assess that the costs involved in calculating the transaction costs using the method provided in paragraphs 12 to 20 of Annex VI of the PRIIPs RTS are disproportionate compared to their significance. In such cases, the firm may use an alternative approach (for example the method provided for in paragraphs 21 to 23 of the Annex VI of the PRIIPs RTS) to calculate transaction costs, provided that it identifies the actual transaction costs associated with the transaction, and that it clearly discloses to clients the basis on which transaction costs have been calculated."

Q15 ESMA Q&A: "Where data on actually incurred transaction costs are not available, the investment firm shall make reasonable estimations of these costs, provided that it identifies all expected transaction costs associated with the transaction, and that it clearly discloses to clients the basis on which transaction costs have been estimated."

4.1 Should the PRIIPs methodology be used for the calculation of transaction costs?

To calculate transaction costs, whether for a product or for service costs, it is expected to be useful for firms to use the PRIIPs methodology regardless of whether the product is a PRIIP or not. However, it is unlikely that firms will find it useful to use the PRIIPs methodology for non-packaged products, such as corporate shares or sovereign bonds.

For product costs, when calculating costs and charges of packaged products (i.e. the only products where product costs arise), firms are may wish to use the methodology in Annex VI of the PRIIPs RTS.

For service costs, when calculating the 'costs related to transactions initiated in the course of the provision of an investment service' on ex post basis, firms may wish to use the methodology as covered in paragraphs 12 to 20 of Annex VI of the PRIIPs RTS, whereby firms should compare the mid-price of an asset at the time at which the order is transmitted to their broker, with the executed price, in order to give the transaction cost.

For ex ante disclosures (or for ex post where this method is disproportionate to the significance of the costs), firms may wish to use the methodology covered in paragraphs 21 to 23 of Annex VI of the PRIIPs RTS. This methodology allows for implicit costs to be calculated using average bid-ask spreads of relevant reference indexes to calculate the estimated cost of the transaction for each asset class under normal market conditions.

4.2 Should there be a *de minimis* threshold on the costs that need to be calculated/disclosed?

As spreads on equity (and similar) instruments are very fine, it is sensible for a *de minimis* threshold to be adopted when disclosing costs. It is submitted that any costs that will need to be rounded up to reach the minimum threshold for disclosure as a cost are not included.

5. Third Party Payments

Annex II MiFID II Delegated Regulation: See below.

Q7 ESMA Q&A: "With regard to inducements, ESMA is aware of the fact that PRIIPs manufacturers are required to present inducements as costs of the PRIIP, mentioned separately from other costs in the KID. As investment firms need to include inducements in the costs of the investment services, any inducements mentioned as costs of the PRIIP should be added to the costs of the investment services and deducted from the costs of the PRIIP (as mentioned in the KID)."

Q13 ESMA Q&A: "In accordance with article 24(4) MiFID II and article 50(2) of the MiFID II Delegated Regulation, firms shall aggregate costs and charges in connection with the investment service and costs and charges associated with the financial instruments. Third party payments received by investment firms in connection with the investment service provided to a client shall be itemised separately. The aggregated costs and charges shall be totalled and expressed both as a cash amount and as a percentage.

Investment services and/or ancillary services	*€ 1.500*	*1.5%*
Third party payments received by the investment firm	*€ 500*	*0.5%*
Financial instruments	*€ 1.500*	*1.5%*
Total costs and charges	*€ 3.500*	*3.5%*

In addition, the investment firm shall provide an itemised breakdown at the request of the client. ESMA would expect that an investment firm take reasonable steps to minimise the effort for the client to submit such requests. When disclosing costs and charges in an online environment for instance, a best practice would be to enable the client to access such information through the use of hyperlinks. ESMA also considers it a best practice when an investment firm actively informs its clients on their right of submitting such a request when providing the aggregated information.

When an itemized breakdown is requested by the client, an investment firm should provide such breakdown (in a consistent way such that cost items may be aggregated) at least at the level of the cost items that are depicted in the tables included in Annex II MiFID II Delegated Regulation:

- One-off charges;
- Ongoing charges;
- All costs related to transactions;
- Any charges that are related to ancillary services (not applicable to financial instruments);
- Incidental costs.

This also applies to firms that use an all-in fee for their investment services. However, ESMA notes that firms only need to disclose cost items that are actually incurred by the client (which in the case of an all-in fee, may for example include exit or entry fees paid to fund manager or stamp duty). The obligation to aggregate costs and charges is without prejudice to any other obligations to provide clients with cost information. For instance, for financial instruments that are within the scope of PRIIPs Regulation, a KID will be distributed to retail investors by investment firms that advise or sell a PRIP, thus providing information on ex-ante costs and charges per individual PRIIP."

This also applies to firms that use an all-in fee for their investment services. However, ESMA notes that firms only need to disclose cost items that are actually incurred by the client (which in the case of an all-in fee, may for example include exit or entry fees paid to fund manager or stamp duty). The obligation to aggregate costs and charges is without prejudice to any other obligations to provide clients with cost information. For instance, for financial instruments that are within the scope of PRIIPs Regulation, a KID will be distributed to retail investors by investment firms that advise or sell a PRIP, thus providing information on ex-ante costs and charges per individual PRIIP."

5.1 How should third party payments (including trail commission) be disclosed?

ESMA's Q&A (Q13) appears to require (in the table) that any third party payments received by a firm to be itemised separately and included in the overall aggregated figure and percentage. UK Finance's view is that as third party payments or non-monetary benefits received by a firm are not a cost or charge that is charged to a client in connection with an investment service or ancillary service, any third party payments or non-monetary benefits received by a firm should be disclosed and itemised separately but do not need to be included in the overall aggregation exercise. This is supported by Article 24(4) of MiFID II which states that, "Third party payments received by investment firms in connection with the investment service provided to a client shall be itemised separately." Conversely, any payments paid by the firm to a third party in connection with the investment or ancillary service should be itemised separately and included in the aggregation exercise. Any non-monetary benefits provided by the firm to a third party should be separately disclosed and described in a generic manner.

In relation to monetary/non-monetary benefits paid on a holistic fee/services basis (as opposed to per product or service), these would be addressed in the same way as for flat service fees discussed above.

6. Limited Disclosure

Article 24(4)(c) MiFID II Directive: "The information on all costs and associated charges must include information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing any third-party payments."

Article 50(1) MiFID II Delegated Regulation: "For the purposes of providing information to clients on all costs and charges pursuant to Article 24(4) of Directive 2014/65/EU, investment firms shall comply with the detailed requirements in paragraphs 2 to 10.

Without prejudice to the obligations set out in Article 24(4) of Directive 2014/65/EU, investment firms providing investment services to professional clients shall have the right to agree to a limited application of the detailed requirements set out in this Article with these clients. Investment firms shall not be allowed to agree such limitations when the services of investment advice or portfolio management are provided or when, irrespective of the investment service provided, the financial instruments concerned embed a derivative.

Without prejudice to the obligations set out in Article 24(4) of Directive 2014/65/EU, investment firms providing investment services to eligible counterparties shall have the right to agree to a limited application of the detailed requirements set out in this Article, except when, irrespective of the investment service provided, the financial instruments concerned embed a derivative and the eligible counterparty intends to offer them to its clients."

Q19 ESMA Q&A: "Article 50(1) of the MiFID II Delegated Regulation allows - in certain situations described in paragraphs 2 and 3 thereof - for a limited application of some of the detailed requirements set out in Article 50. The more limited application which needs to be agreed by the two parties should however never lead to disapplying the obligations imposed on investment firms pursuant to Article 24(4) MiFID II.

ESMA emphasizes that Article 24(4) MiFID II requires that the information provided to clients, amongst others, includes information on all costs and charges, including information relating to both investment and ancillary services, the financial instrument recommended or marketed to the client and any third-party payments. In addition, the information shall be aggregated and where the client so requests, an itemised breakdown shall be provided. The information about costs and charges shall be provided to the client in good time before the investment service is provided and, where applicable, on a regular basis, at least annually.

Recital 74 provides examples of detailed requirements which could be the object of such limited applications under article 50 of the Delegated Regulation. For instance, the investment firm could agree, at the request of the client, to not provide the illustration showing the cumulative effect of costs on return, not provide an indication of the currency involved and not provide the applicable conversion rates and costs where any part of the total costs and charges is expressed in foreign currency."

ESMA Guidelines on complex debt instruments and structured deposits (ESMA/2015/1787): "An embedded derivative is a component of a host contract or instrument – such as a debt instrument - that causes some or all of the cash flows that otherwise would result from the contract or instrument to be modified according to a defined variable such as the price of a security or the level of a market index or an interest rate or foreign exchange rate. The list below, which is non-exhaustive, sets out types of debt instruments that are generally deemed to embed a derivative:

- Indexed bonds and "turbo" certificates: Indexed bonds and "turbo" certificates are debt instruments the pay-off of which – i.e. the coupon or the repayment of principal or both - is based on a formula that is typically related to the level of an equity index, individual equity price or other price level. They must be considered to embed a derivative and should therefore be deemed to be complex securities.
- Convertible and exchangeable bonds: Bonds that holders or issuers may convert or exchange into shares of the bond issuer (or shares of another company, such as an affiliate) are common in the capital markets. The option to exercise such a right to convert or exchange is to be

understood as indicating that they embed a derivative. Convertible and exchangeable bonds (regardless of the type of security to which the conversion or exchange gives rise) are therefore deemed to be complex securities for the purpose of Article 25(4) of MiFID II. These bonds, as well as several of the other securities discussed below, may also be considered complex by virtue of the provision in Article 38 of the current MiFID implementing directive (and that should be maintained under MiFID II) that deems complex any security that falls under point (c) of the definition of transferable securities (currently Article 4(18) of MiFID; Article 4(1)(44) of MiFID II).

- Contingent convertible bonds: Contingent convertible bonds (cocos) are debt securities where the principal amount may be cancelled, reduced or converted into equity in certain circumstances relating, for example, to the level of own funds of the issuing institution, and/or the coupon payable modified in a discretionary way by the issuer. Their features indicate an embedded derivative, and therefore cocos should be deemed complex. In addition, cocos may be deemed to incorporate a structure making it difficult to understand the risk since these instruments are governed by complex legal documentation which could be challenging for investors to understand. This alternative approach would be relevant, however, only where the relevant cocos may be considered as not embedding a derivative.
- Inflation-indexed bonds: A bond where repayment of the principal or the coupon amount varies with an inflation rate should be considered as embedding a derivative. Therefore, it should be deemed complex.
- Callable or puttable bonds: A callable bond allows the issuer to impose the repayment of principal before the normal maturity of the bond. A puttable bond allows the investor to sell the bond back to the issuer in defined conditions. Both of these bond types embed a derivative and should accordingly be deemed complex securities.
- Credit-linked notes: A credit-linked note is essentially a security with an embedded credit default swap, allowing the issuer to transfer a specific credit risk to investors. It should therefore be deemed to be a complex security.
- Warrants: Most warrants are similar to options, but they are securities in many legal systems (for example, they are admitted to the operations of central securities depositories and have ISIN codes) and not derivatives within the meaning of points (4) to (10) of Annex I of MiFID. Such securities must be deemed to embed a derivative and should therefore be deemed complex. Where under the legal system of a particular jurisdiction, warrants are considered to be derivatives (and classified in points (4) to (10) of Annex I of MiFID), they will be deemed complex by virtue of Article 38 of the MiFID implementing Directive."

6.1 When should firms agree to receive limited disclosure?

As this guidance relates to firms and their retail businesses, it considers in what circumstances firms who may be approached by other firms (manufacturers) to provide limited disclosure should agree to do this.

Firms should only agree to receive limited disclosure from manufacturers, and such limited disclosure can only be agreed to in the first place if the product does not embed a derivative, where the manufacturer agrees to provide the firm with access to the underlying product data/information that is needed by the firm in order to be able to satisfy its own disclosure requirements. If this cannot be agreed, then a firm should not agree to receive limited disclosure.

6.2 What does 'embed a derivative' mean?

In terms of when a firm can agree to receive limited disclosure, a firm that sells a derivative to a firm is not selling a product that 'embeds a derivative' as the product that is being sold is a derivative. Similarly, where a firm enters into a derivative with a third party firm purely for the purposes of hedging its risk position against a product it has bought from a third party firm, that does not embed a derivative. Products that embed a derivative are those such as structured products/structured deposits.