INSTITUTE FOR THE FIDUCIARY STANDARD

Fiduciary Reference

Analysis of Issues in Financial Advice

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EU's New Rule, MiFID II, Requires Actual Disclosure of Investment "Costs and Charges"; SEC's Reg BI Does Not

The rigorous EU disclosure requirement contrasts with Reg BI's requiring disclosure of a list of fees or potential fees

Knut A. Rostad and Darren M. Fogarty*

Executive Summary

The Markets in Financial Instruments Directive II (MiFID II) was put in place in Europe in January 2018. The rule aims to increase clarity in European Financial markets by requiring "providers of investment services" (advisors), to clearly detail how much their products and advice cost. It requires disclosure of projected costs looking forward, and actual costs and charges, for the prior year in absolute and percent terms. The disclosure requirement for actual costs is new, with many firms only coming into compliance in Q1 of 2019.

MiFID II's standard raises the transparency bar well above the U.S. SEC's proposed Regulation BI and Form CRS. They only require a list of the tasks and services which will or may incur a cost or charge.

Key Takeaways

- MiFID II responds to US investors' ongoing demands for greater clarity and transparency around all-in costs. The new rule requires financial professionals to provide an overview of costs and charges to clients based on "actually incurred costs." Costs and charges must be "totaled and expressed both as a cash amount and as a percentage" and professionals must provide an "itemized breakdown" at the request of the client.
- MiFID II requires telling clients what they pay. Form CRS requires telling customers how brokers and BDs are being paid. It uses vague language, telling the investor they charge "a fee" and that there are "additional fees," each of which may "vary" and may be "negotiable."
- Regulation Best Interest (Reg BI) and Form CRS should be re-engineered to resemble this MiFID II requirement and heed SEC Commissioner Peirce's recommendation by "requiring firms to spell out clearly the services they are offering and the fees they charge."[1]

[1] US SEC Commissioner Hester Peirce's Statement at https://www.sec.gov/news/public-statement/statement-peirce-041818

* Knut A Rostad is President and Founder of the Institute for the Fiduciary Standard. Darren M Fogarty is Research Analyst at the Institute. The Institute is a non-profit that exists to advance the fiduciary standard through research, education and advocacy. For more information see www.thefiduciaryinstitute.org.

Introduction

The Markets in Financial Instruments Directive (MiFID) is a 2007 regulation that increased transparency and standardized disclosures across the European Union's financial markets. MiFID II, put in place in January 2018, "seeks to address the failings of MiFID I" by "making the market easier to understand" for investors. A chief component: Requiring advisors to "tell investors more about what products they sell and how much they cost."[2]

The new directive matters. Here are two reasons why: (1) MiFID II's requirements on straightforward, transparent disclosure of investment expenses are what investors want and (2) they are what the Regulation Best Interest's (Reg BI) Form CRS *should require*. MiFID II's requirements and guidance also reflect what the Institute requires in its Real Fiduciary™ Practices and has for the past 3 years. Research underscores how much investors want fees to be transparent, and TD Ameritrade's Tom Nally has pointed out how frustrating getting this information can be. Yet, it should be obvious how knowing investing costs is necessary if investors are to make informed decisions of about their financial choices.

Background

The complex landscape of financial products and 'advice' and how it is communicated is confusing to investors. RAND's 2018 Study (OIAD) found that "about a quarter of [investors]" stated not knowing if they paid a particular type of fee or not, and that "[m]ore than 20 percent reported paying nothing."[3]

Why is it that investors are unaware of the fees and costs they are paying? The conventional answer is that the fault lies with the investor. In this view, investors are confused; the implication being that they are either unintelligent, uninformed, or both. The more accurate answer, outlined in a recent Institute paper, is that investor shortcomings result from confusing and misleading communications emanating from the financial services industry.[4] Regulators on both sides of the Atlantic have offered two different solutions to this problem.

European regulators crafted MiFID II to improve the investment climate for consumers, and the U.S. SEC proposed Reg BI. The objectives of MiFID II resemble the *stated* objectives of the U.S. SEC's Regulation Best Interest (Reg BI), which are, according to Chairman Jay Clayton:[5]

- "To fill in the gaps between investor expectations and legal requirements";
- "To increase investor protection and the quality of advice";
- "[To mandate] clear disclosures"; and
- "[To raise] the standard of conduct" for BDs

[2] Zurich Intermediary Group, "The Introduction of Markets in Financial Instruments Directive II (MiFID II)" at https://www.zurichintermediary.co.uk/en-gb/wealth/mifid-ii.
[3] The Retail Market for Investment Advice, https://www.sec.gov/comments/s7-07-18/s70718-4513005-176009.pdf at 63-64.
[4] See Institute's Paper, https://thefiduciaryinstitute.org/2019/01/15/conventional-wisdom-says-a-major-problem-is-investor-confusion-about-brokers-and-advisers-is-this-the-whole-story/
[5] U.S. SEC Chairman Jay Clayton, "Statement at the Open Meeting on Standards of Conduct for Investment Professionals" at https://www.sec.gov/news/public-statement/clayton-statement-open-meeting-iabd-041818.

A Side-by-Side Comparison Reveals How Different They Are

While the stated objectives of MiFID II and Reg BI are similar, the actual language of each is different.

MiFID II: MiFID II's Question & Answer document[6] details precisely how investment fees and expenses should be disclosed to clients. Excerpts of its language read as follows (emphasis added):

> *(1) [F]irms 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****";[7] (2) [T]he investment firm shall provide an itemised breakdown at the request of the client … [which provides] …* ***one-off charges, ongoing charges, all costs related to transactions, any charges that are related to ancillary services, incidental costs****";[8](3) when calculating costs and charges on an ex-ante basis, an investment firm shall use* ***actually incurred costs as a proxy for the expected costs and charges.****"*[9]

Reg BI and Form CRS: The SEC's Form CRS differs sharply from MiFID II on fee and expense disclosure requirements. Its Hypothetical Disclosure[10] requires BDs to only disclose *what* kinds of fees will be paid, not *how much fees are (or will be) paid*. Essentially, *how* the firm and broker are compensated; not *what* the firm and broker are compensated. Excerpts of its language read as follows (emphasis added):

> *(1) "You will pay us* ***a fee*** *every time you buy or sell an investment … based on the specific transaction and not the value of your account"; (2)"Some investments … impose* ***additional fees*** *[such as surrender charges to sell the investment]"; (3) "Our* ***fees vary*** *and are* ***negotiable****"; (4) "We charge you* ***additional fees****, such as custodian fees, account maintenance fees, and account inactivity fees"; (5) "You will pay an on-going fee at the end of each quarter based on the value of the cash and investments in your advisory account"; (6) "The more assets you have in the advisory account …* ***the more you will pay*** *us."*

The takeaway? MiFID II requires advisors to provide "an overview of the total costs and charges incurred in the previous year" or concrete estimates of the actual charges of investment fees and expenses. Form CRS only offers guidance on when and how certain fees may be applied. MiFID II requires clear disclosure of material facts. Form CRS does not.

Ron Rhoades, Professor at Western Kentucky University and prolific researcher and author on fiduciary duties, has compiled an exhaustive list of 21 different fees and other forms of compensation a broker-

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[6] European Securities and Markets Authority (ESMA), "Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics" https://www.esma.europa.eu/sites/default/files/library/esma35-43-349_mifid_ii_qas_on_investor_protection_topics.pdf

[7] Ibid, at 73.

[8] Ibid, at 78-79.

[9] Ibid, at 79.

[10] Appendix C of Form CRS, "Hypothetical Relationship Summary for a Dually Registered Adviser and Broker-Dealer," at https://www.sec.gov/rules/proposed/2018/34-83063-appendix-c.pdf.

dealer or an investment advisor might receive.[11] The sheer number of compensation types leads one to a straightforward conclusion: It is impossible to expect an investor to know what he or she is actually paying, and what the firm and broker are making, for services rendered.

What Do Practitioners, Academics, and Legal Counsel Have to Say about MiFID II?

Richard Stott, CFA® Charterholder and Partner at the Oslo-based firm, Connectum, is in the midst of complying with the new rule. He expresses the view that MiFID II compliance is "complex":

> *"The whole issue of MiFID II cost reporting is complex ... Given the need to show the effect of aggregated costs on returns and the need to itemise the costs separately one wonders whether clients might not feel overwhelmed. Many custodians are looking to produce this information where all costs are taken through a particular account. When engaging new clients, you will also have to show the assumed growth rate and the potential effects of charges thereon. With regulation ever-tightening, one wonders at what point advisers will end up spending too much time on compliance and not enough time focussed on their clients."*

Rosalyn Breedy, Partner at Wedlake Bell LLP, a London-based Law Firm, offers a comprehensive commentary on MiFID II (attached). She confirms that MiFID II substantially raises the bar for providers of investment services serving clients in the European Economic Area (EEA), writing:

> *"[P]roviders of investment services [must] disclose all costs and charges related to the financial instrument and ancillary services, including the cost of advice, and where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, including any third party payments. Third party payments received by investment firms in connection with the investment service provided to a client must be itemised separately and the aggregated costs and charges shall be totalled and expressed both as a cash amount and as a percentage."*

Breedy also noted that, while firms were finding some parts of MiFID II compliance difficult, a UK review of 50 firms complying with MiFID II concluded, in part (emphasis added):

- *"Firms need to ensure that* ***costs and charges disclosures in advertising materials were consistent with what was reported to clients****."*
- *"Firms need to* ***take reasonable steps to minimise the effort required for a client to request an itemised breakdown****."*
- *"Firms should use example numbers based on* ***customer actual experience*** *as opposed to numbers that were easy to calculate."*

Robin Powell, UK Journalist and Editor of The Evidence-Based Investor, provides insight on how MiFID II moves the needle in terms of how European financial advisors must act:[12]

[11] Ron Rhoades, "Comments on Regulation Best Interest and Form CRS Relationship Summary," https://www.sec.gov/comments/s7-07-18/s70718-4728948-176763.pdf at 12-13.
[12] Personal Communication with Robin Powell, February 12, 2019. Website: https://www.evidenceinvestor.com/home-us/

> *"MiFID II removes the veil of secrecy from European asset management … [It] goes one step further than the Best Interest rule. It's not just about disclosing, conflicts of interest, and showing diligence and care.* ***It's about demonstrating, in pounds and pence or euros and cents, exactly how much the client is paying****. Morningstar research has repeatedly shown that cost is the most reliable predictor of future returns."*

MiFID II is also relevant to U.S. Wealth Management and BD firms with clients in Europe. Samantha Regan, Managing Director of Finance & Risk Practice at Accenture, a global management consulting firm, elaborates on this point:[13]

> *"Although MiFID II initially impacts firms based in Europe, US based Asset Managers competing for mandates against European investment firms could face competitive pressure to adhere to MiFID II rules. The regulation is most relevant to global asset managers that are based in the US but have a physical location in Europe where they serve European clients, said Tom Conigliaro, managing director at Markit Brokerage and Research Services. While global firms can continue to operate their US divisions under existing US rules, "operating a global business under two starkly different regulatory regimes is very challenging," says Conigliaro."*

How these firms adapt to and comply with MiFID II will give actionable steps for other American RIAs and BDs to follow. Among other implications, it will mean these firms will make strides towards meeting fee-disclosure requirements in the Institute's Real Fiduciary™ Practices.

Conclusion: MiFID II is 'In Tune' With What Investors Expect of Financial Professionals

Investors are unambiguous about what they expect from their financial professionals on key issues. RAND's 2018 study (OIAD) found that 51% of retail investors consider it important or extremely important that their "financial professional receives all of his/her compensation from [them] directly." They also believe that a 'best interest' standard (as found in Reg BI) should mean that their advisers "will disclose payments they received that may influence them" (59% agree vs. 19% disagree).[14]

MiFID II provides what investors want and expect on fee transparency. This contrasts with Reg BI. As noted by SEC Commissioner Peirce the proposed rule "does not offer much concrete information for investors … to get a sense of what they might pay."[15]

The SEC should take note of MiFID II. Form CRS should require financial professionals to disclose actual fees and expenses investors pay. Not doing so falls short of investors "reasonable expectations."

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[13] Samantha Regan. "MiFID II and What it Means for US Asset Managers." Available at: https://financeandriskblog.accenture.com/regulatory-insights/regulatory-alert/mifid-ii-and-what-it-means-for-us-asset-managers

[14] The Retail Market for Investment Advice, https://www.sec.gov/comments/s7-07-18/s70718-4513005-176009.pdf, at 65-66 and 72, for statistics respectively.

[15] US SEC Commissioner Hester Peirce, "Statement at the Open Meeting on Standards of Conduct for Investment Professionals," at https://www.sec.gov/news/public-statement/statement-peirce-041818

Wedlake Bell

IMPACT OF THE MIFID II COSTS AND DISCLOSURES REGIME

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'United wishes and good will cannot overcome brute facts,' Churchill wrote in his War Memoirs. 'Truth is incontrovertible. Panic may resent it. Ignorance may deride it. Malice may distort it. But there it is.'

Summary of the requirements

MIFID II directive (2014/65/EU) article 24.4 and supporting Delegated Regulation 25.4.2016 Article 50 and 59.9 requires providers of investment services to disclose all costs and charges related to the financial instrument and ancillary services, including the cost of advice, and where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, including any third party payments.

Third party payments received by investment firms in connection with the investment service provided to a client must be itemised separately and the aggregated costs and charges shall be totalled and expressed both as a cash amount and as a percentage.

Where any part of the total costs and charges is to be paid in or represents an amount

of foreign currency, investment firms must provide an indication of the currency

involved and the applicable currency conversion rates and costs.

Investments firms must also inform about the arrangements for payment or other performance.

The information must be disclosed on both a forecast and actual costs incurred basis.

Finally, the client must be provided with an illustration showing the effect of the overall cost and charges on the return of investment.

This must occur on a forecast and actual basis (the latter occurring regularly and at least annually during the life of the investment).

Scope of the requirements

The costs and charges disclosure requirement would apply to financial planners, wealth managers, asset managers, discretionary investment managers and stock brokers acting on behalf of retail investors in the EEA.

Investment firms providing investment services to professional clients are able to agree a limited application of the detail requirements set out in the Delegated Regulation but not where the services of investment advice or portfolio management are provided or when, irrespective of the investment service provided, the financial instruments concern embed a derivative.

Similarly, investment firms providing investment services to eligible counterparties have the right to agree to a limited application of the detail requirements set out in the Delegated Regulation, except when, irrespective of the investment service provided, the financial instrument concerned embed a derivative and the eligible counterparty intends to offer them to this clients.

Impact of the requirements

Timing

The requirements have been in place since 3rd January 2018. In practice this has meant disclosure for all forecast costs for new MIFID investment sales since 3rd January 2018. There has been more variance of disclosure for actual costs with many investment firms counting a year since year –end valuation on 31 December 2018 meaning that many clients received the actual costs disclosure for the first time by 31 January 2019.

Challenges

Forecast costs

Investment firms have had to base these on simulated models which aim to show the potential indicative running costs of a portfolio and/or investment advice. This means that assumptions are made about transaction volumes, asset choices and portfolio performance.

Actual costs

It can be a challenge obtaining and reporting actual costs in a consistent manner from the range of parties involved i.e. product manufacturers, execution venues and investment advisers.

Reporting

Providers of investment services have to provide clients with an aggregated overview of all the service costs and charges, as well as any recommended solutions.

Illustrating the cumulative effect of costs on return should not be seen as a separate disclosure but instead a continuation of the aggregated costs and charges disclosure.

Unfortunately, there is not a standardised format for demonstrating the cumulative effects. Firms have used graphs, tables and text.

Anomalies

Not all product manufacturers have disclosed ongoing charges in MIFID II compliant manner.

It has not been easy to source the required MIFID II costs including transaction costs and borrowing costs for UCITS funds as they are not currently reflected within UCITS Key investor information documents and the new Packaged Retail and Insurance- based Investment Product Regulation ("PRIIIPS") is not yet in place.

Also, there are discrepancies between the calculation of transaction costs between MIFID II and PRIIPS. Fund managers calculating under MIFID II use a bid and offer spread whereas PRIIPs methodology allow the inclusion of slippage i.e. the difference between the price at which a trade is executed and the 'arrival price' when the order to trade is transmitted to the market. .. . which can yield a zero transaction cost.

Non-European Union providers are not obliged to comply with MIFID II methodologies and as such MIFID ii firms have to obtain that data on a "best endeavours" basis.

How are firms responding?

The UK Financial Conduct Authority published in January 2019 a review of 50 MIFID investment firms providing investment services to retail clients and concluded that:

- Firms knew about their obligations for disclosing costs and charges but were interpreting rules in a variety of ways.
- Firms were better at disclosing the costs of their own services than at disclosing relevant third party costs and charges.
- A number of firms had not shared their costs and charges with each other to meet their obligations to provide aggregated figures to clients.
- Firms needed to work on producing estimates where they could not obtain data in items such as transaction and incidental costs and not merely report them as zero.
- Firms need to ensure that costs and charges disclosures in advertising materials where consistent with what was reported to clients.
- Firms need to take reasonable steps to minimise the effort required for a client to request an itemised breakdown. ESMA suggests that best practice for disclosing costs and charges online would be to enable a client to get this information through hyperlinks.
- Firms should use example numbers based on customer actual experience as opposed to numbers that were easy to calculate.

CONTACT

ROSALYN BREEDY
Partner
T: +44 (0) 20 7406 1629
E: rbreedy@wedlakebell.com

Business Services

Dispute Resolution

Private Client

Real Estate

Wedlake Bell LLP
71 Queen Victoria Street London EC4V 4AY DX 307441 Cheapside
T: +44 (0)20 7395 3000 | F: +44 (0)20 7395 3100 | E:
legal@wedlakebell.com

www.wedlakebell.com