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MiFID II: Are we heading towards an inducements ban?

Following the European Commission's request of late May 2019 for technical advice on certain MiFID II investor protection topics, the European Securities and Markets Authority ("**ESMA**") presented its Final Report at the end of March.

Its report provides technical advice to the Commission on two issues:

- the impact of the MiFID II inducements disclosure requirements; and
- the impact of the general costs and charges disclosure requirements under MiFID II;

taking into account a variety of stakeholder feedback received in response to ESMA's related call for evidence.

Although its technical advice does not recommend a ban on inducements, its use of terms like "*at this stage*" and its recommendations to consider what the impact of a ban might be on the different distribution models across the EU as well as to look at the actual experience in the Netherlands and the UK (where bans have already been introduced) suggest that a ban on inducements might well be the eventual end result.

Impact of MiFID II Inducements disclosure requirements

This briefing focuses on the technical advice issued by ESMA and what its report outlines as the rationale behind that advice, rather than going back over the MiFID II inducements rules which, in summary, provide:

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- that an investment firm will not regarded as fulfilling its obligations under Article 23 (*conflicts of Interest*) or Article 24.1 (*firms must act honestly, fairly and professionally in accordance with the best interests of their clients*) of MiFID II where it pays or is paid any fee or commission, or provides or is provided with any non-monetary benefit in connection with the provision of an investment service or an ancillary service, to or by any party except the client or a person on behalf of a client, except where such inducements:

  (a) are designed to enhance the quality of the relevant service to the client; and

  (b) does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.

  This applies to any provision of an investment service or ancillary service. In other words, it is of general application to all investment firms;

- that where an investment firm is providing portfolio management or independent investment advice, it must not accept and retain third party fees, commissions or any monetary or non-monetary benefit paid in relation to the provision of the service to the relevant client; and

- a variety of disclosure obligations with regard to inducements, those disclosures having to be made at different times in the relationship with the client and in particular ways (which can be different in practice to the disclosure obligations imposed under the UCITS or PRIIPs regimes).

(i) Stakeholder Feedback

In developing its advice, ESMA considered whether and how firms were complying with the inducements disclosure obligations and, more generally, the effects of the inducements rules for clients. Some of the stakeholder feedback included:

- that certain stakeholders found the disclosure obligations to be practically challenging, with others seeking a greater level of harmonisation of the presentation of commission payments to distributors under MiFID II and in the UCITS KIID and PRIIPS KID. ESMA felt that, in the context of the provision of a MiFID service, the MiFID approach was the correct one;

- that certain stakeholders noted that there were different interpretations of the "*quality enhancement condition*" as between different National Competent Authorities ("**NCAs**"). ESMA felt that more work needed to be carried out, in particular additional market research into the unique market features across jurisdictions, before that issue could be tackled;

- stakeholder concerns as to the differing obligations between instruments subject to the MiFID II rules and comparable investment products, such as insurance products, subject to less burdensome obligations. ESMA felt that comparable projects should be subject to the same rules, unless there was a compelling reason supporting divergent rules (although clearly IDD rules are not within ESMA's responsibility);

- perhaps most interestingly, that, notwithstanding the disclosure obligations, clients (mostly retail clients) still find it difficult to understand how commissions affect the independence of advice and they may not know how to adjust their behaviour to the disclosed conflict of interest in any event. ESMA noted that one of the respondents referred to the outcome of a study conducted by the Germany Regulator, BaFIN, "*that shows the limited effect of information disclosure related to inducements and costs – no matter their design and comprehensibility – on client's behaviour*";

- that some respondents indicated that their product offering had not changed as a result of the MiFID II inducements disclosure rules, although others indicated that the rules had been a driver in the creation of more clean share classes and that MiFID II obligations more generally (such as product governance rules) had an impact on product range;

- that one of the respondents indicated that in some markets the vast majority of clients are unwilling to pay for advice and that, for that reason, very few advisers providing independent advice exist; and

- that a significant number of respondents felt that the inducements disclosure requirements had no or very little impact on how clients choose providers or product, with one explaining that "*the independence of their advisors is not, in many jurisdictions, a key criterion for investors' choices which are more influenced by personal trust, the perceived quality of the advice or the diversity and range of products offered*".

(ii) ESMA's conclusions and technical advice

Based on the feedback, ESMA concluded that the inducements disclosure rules have not had the positive impact expected, and have not facilitated the development of independent investment advice.

ESMA's advice to the European Commission is to assess:

- the impact the MiFID II inducements regime has had on the distribution of retail investment products across the EU;

- the effects a ban on inducements would have on the different distribution models existing in the EU; and

- the actions that could be taken to mitigate the risk of undesired consequences of an inducements ban

ESMA recommended that to assess the potential positive or negative effects of a ban, the impact of the bans as introduced in the Netherlands and the UK should be examined.

Pending the outcome of any such assessment, ESMA also set out a number of actions designed to improve clients' understanding of inducements, in particular to improve the comprehensibility and clarity of the existing inducements disclosures (and recommended the use of layman's terms) and also requiring firms to bring to their clients' attention the specific quality enhancing services that they are already benefitting from or that they could benefit from if they requested or used the service.

Although it said that "*at this stage, ESMA does not recommend…to ban inducements completely for all retail products across the Union…",* its recommendation that the impact of a ban be examined and that examination include a review of those jurisdictions which have already introduced such a ban, suggests to us that the industry should prepare itself for an eventual complete ban.

Costs and Charges Disclosure

The second matter that ESMA was asked by the Commission to consider and report on was the cost and charges disclosure requirement under Article 24(4)(c) of MiFID II.

In similar fashion, ESMA detailed the feedback received and its analysis of that feedback. Although noting that the regime generally works well and that it has helped investors make informed investment decisions, ESMA's technical advice, in summary, was that the MiFID II costs and charges disclosure regime should allow for more flexibility when applied to eligible counterparties and professional clients:

- *Eligible counterparties* - should be allowed to opt-out of the entire costs and charges disclosure regime and the obligation to provide the illustration of the impact of costs on return should not apply at all.

- *Professional clients* - more flexibility should be provided, depending on the type of service provided rather than on whether the client is a *per se* professional client or an opt-up professional client. Professional clients, both per se and opt-up should be allowed to opt-out of the entire costs and charges disclosure regime except where .investment advice or portfolio management is being provided.

ESMA recommended that firms keep records of the documented requests to opt-out and should contractually agree with clients what type of costs information the client will receive instead.

The report also recommended amending Article 3 of the MiFID II Delegated Regulation so that when information is required be provided in a durable medium, the provision of that information by means of electronic communications should become the default option. Firms should also be required to provide clear information to their clients as to the consequences attached to the provision of a valid email address, and that in such a case no information will be provided in a paper form, unless explicitly requested by the client.

Finally, the Technical Advice recommended that the MiFID II Delegated Regulation be amended so that firms are no longer required to personally address their best execution and conflicts of interest policies to their clients, once those policies are freely accessible on the firm's website.

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