The transparency of MiFID II costs and charges

Are the disclosures helping clients make better decisions?

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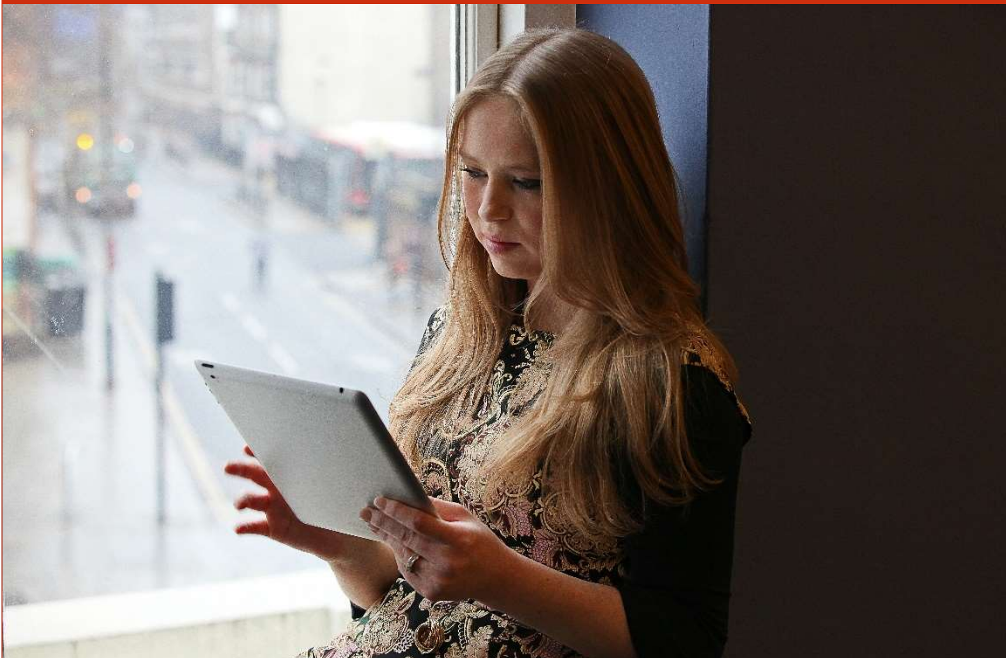

MiFID II – discussion paper

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Executive Summary

As part of improving levels of investor protection afforded to clients, MiFID II requires investment firms to provide disclosure of costs and charges to enable clients to make more informed decisions about who they wish to trade with, and ultimately apply downward pressure on the charges which they pay.

This is a broad new requirement upon investment firms which requires them to define, and then calculate and capture, these costs and charges, so that they are able to provide all the necessary disclosures.

In order to deliver all of the new requirements, firms have needed to develop suitable methodologies, design and implement technology solutions, and embed new processes and controls to manage the process of capturing data and providing disclosures. Given the scale of the requirements and changes required, many firms have deferred some non-critical day 1 activities and are using 2018 to complete or enhance what has already been implemented.

Implementation has been further complicated because of a lack of specific or prescriptive regulatory guidance. This has, to some extent, left firms to develop their own approaches.

Our analysis of 32 sell side published disclosures shows that firms have adopted a wide variety of approaches to address the new requirements and have provided differing levels of transparency. Some have provided detailed disclosures of costs and charges on a product by product basis, whilst others have provided a minimal restatement of the regulatory requirements. Most firms have fallen somewhere between the 2 extremes disclosing most of the information required.

Given the disparity in responses, our view is that clients of sell side firms will find it difficult to perform meaningful analysis of costs and charges when choosing between firms and therefore it is not clear at this time that the new costs and charges regime will bring about the hoped-for benefits.

Whilst regulators assess where industry has landed on disclosures and whether this has achieved the desired outcomes, firms should consider benchmarking themselves against others in industry to assess their own regulatory status in anticipation of potential challenge from their regulators or their own clients.

This paper draws on our experience of the regulation and highlights some of the key challenges that need further thought, and the potential outcomes for the industry as a consequence of the new costs and charges obligations. It includes:

- An overview of the MiFID II costs and charges requirements.
- Key challenges that sell side firms have had to overcome.
- Our analysis of 32 sell side disclosures and what this tells us about the state of sell side disclosures.
- What some firms need to be doing in 2018 to optimise what they have already built.
- Implications associated with the new requirements both for the sell side firms producing the disclosures and end clients trying to perform comparisons.

MIFID II introduces new costs and charges disclosure requirements

A key objective of MiFID II is to improve the level of protection provided to investors. One way in which the regulation seeks to achieve this is by requiring investment firms to provide an increased level of transparency to clients including extensive disclosures relating to costs and charges.

Additional disclosures afford increased protection for clients in one of two ways. Firstly it better equips clients with data such that they are able to make more informed decisions on who they transact with and the cost of the products which they trade, to enable them to seek value from their spend. Secondly it applies pressure on investment firms to keep costs and charges to a minimum or at least in line with their peers.

The specific costs and charges requirements are set out in Article 24(4) of MiFID II and Article 50 of the Delegated Regulation. Under the requirements firms are obligated to:

- Disclose all costs and charges on an ex-ante (pre-trade) and ex-post (post-trade) basis for a) costs associated with transacting financial instruments b) costs associated with the investment/ancillary service being provided and c) third party payments that have been received by the investment firm.

- Present costs and charges as both a percentage and cash amount.

- On an ex-ante and ex-post basis, provide an illustration showing a) the effect of the overall costs and charges on the return of the investment, b) any anticipated spikes or fluctuations in the costs, and c) narrative to describe the illustration.

- Provide an itemised disclosure of costs and charges to clients upon request, based on categories defined in the regulation. Costs relating to financial instruments must be broken down into 5 categories, while costs relating to investment and ancillary services must be broken down into 4 categories. There is no limitation specified on the time in which the client can request this information. In principle a client has the right to request such a breakdown for any costs and charges following MiFID II coming into force.

- Provide an aggregated costs and charges statement on an annual basis.

Implementation across the industry has been varied and different firms have interpreted the rules differently. This has led to a wide variety of responses across both the buy side and sell side firms, some of which have been analysed in this paper.

Complying with the new requirements has not been a trivial exercise

Investment firms have spent a significant amount of time and resources implementing MiFID II costs and charges requirements. It has proven to be one of the more complex and challenging areas of the MiFID II regulations from both a commercial and technology point of view, given the number of touch points with business processes across most asset classes, and the need to balance the risk of disclosing too much to clients yet respecting new regulatory requirements.

Although there has been much debate on how best to interpret the requirements and therefore implement, most investment firms have primarily undertaken three key blocks of activity to help ensure they comply with new requirements.

Definition of methodology

Firms have needed to define a suitable methodology for defining, calculating, and classifying costs and charges for their products and services in order to provide their clients with appropriate and meaningful information.

This has been made more challenging by the lack of prescriptive regulatory guidance on how this should be done, so firms have to some extent been forced to define their own approaches.

In the absence of clear guidance, and to provide more certainty on interpretation to senior management, investment firms have often validated or discussed their proposed approaches with external advisors.

Scoping

Firms have needed to assess global booking models and extraterritorial impacts to identify to what extent trades booked from outside the EEA into an EEA firm, or from the EEA into a non-EEA firm, fall within the scope of costs and charges requirements.

Timing of ex-ante disclosure

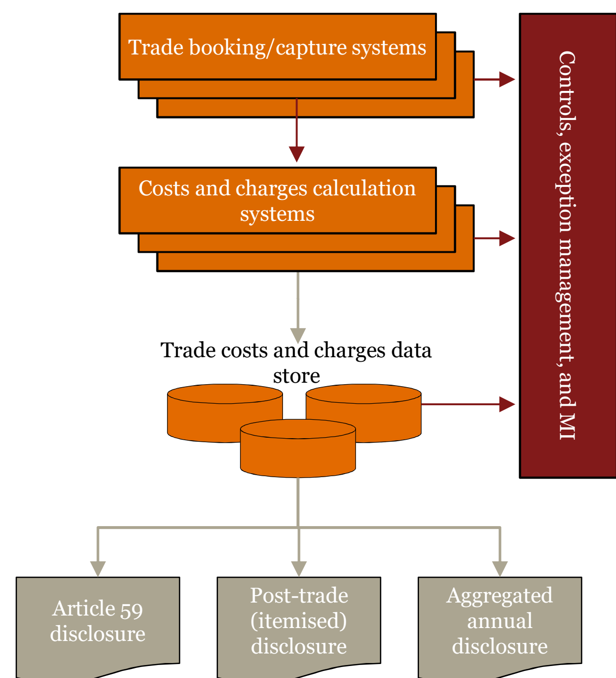
The provision of cost information to clients which is specific to the trades which they plan to undertake enables them to make the most informed decisions.

Particularly in flow businesses, the pace of trading is often rapid, making it challenging to produce client and/or trade-specific disclosures on a pre-trade basis. Given the impact that this would have on the speed of execution, firms have typically provided a more generic ex-ante template disclosure. Although this may meet regulator objectives, it is sub-optimal from a client perspective.

Implementation of supporting processes and technology

Firms have needed to implement processes and technology solutions to capture the required data, calculate the costs and charges, generate and provide the various disclosures to clients, and respond to client requests and queries.

This has often been across the stack of disparate systems that support the catalogue of products being provided to clients and has been further complicated by the lack of a unified reporting standard, and the need to be able to produce and validate costs and charges rapidly to support next day Article 59 "enhanced confirmation" reporting. The diagram below provides an overview of a typical data/system flow for costs and charges under MiFID II.



The complexity of weaving the requirements into existing business system stacks and the number of systems involved has resulted in an extensive book of work which firms have needed to complete in order to become compliant. And firms have needed to deliver this alongside other MiFID II requirements, stretching the available resources.

Complying with the new requirements has not been a trivial exercise

Production of the aggregated annual statement

Costs and charges for trading activity will often be calculated at the time of trade and be immediately available. Other costs and charges, such as fees for services provided, may be calculated and invoiced in arrears, potentially weeks after the provision of the service itself. In these instances the timing of the calculation and therefore the availability of the data may impact investment firms ability to produce timely annual disclosures in year 1 of the regulation.

Operating model

The costs and charges regime introduces new reporting requirements and responsibilities for firms. Some firms have grappled with where responsibilities lie for these new requirements and have had to set up structures that support the new requirements. Leveraging existing operating models, firms have needed to either centralise this process or created this functionality within business along with associated hand-offs to other teams within the organisation.

Where firms have landed and unintended consequences

The majority of sell side firms have been able to successfully publish some form of disclosure relating to costs and charges. Some disclosures provide a reasonable level of detail, and are largely meeting the requirements relating to information which firms must provide to clients pre-trade. Others are less comprehensive, and do not on their own come close to addressing the pre-trade disclosure requirements.

We have reviewed a sample of 32 disclosures made available by sell side firms who provide services, predominantly to other eligible counterparties or professional clients, to assess the approach industry is taking to costs and charges. The banks in the sample are of a variety of sizes and geographies.

The analysis provides a useful insight, however as we do not know what these firms may be supplementing the published information with in respect to further detail for individual clients or trades, it is not possible to draw firm conclusions on their overall level of compliance or the usefulness of the disclosure for clients.

Level of disclosure

The most immediate observation from our review is that the level of information in disclosures and the templates used varies significantly, from a minimal restatement of the regulatory requirements at one end of the spectrum to detailed disclosure of costs and charges on a product-by-product basis at the other. Most firms fell in the middle of the pack disclosing most of the information required.

Disparity between disclosures limits the extent to which investors are able to perform meaningful like for like comparison of costs and charges data and therefore impacts their ability to make informed decisions about who they should trade with to put competitive pressure on banks.

Similarly buy-side firms, such as asset managers, are not able to obtain all relevant information required from counterparties to calculate all costs and charges for the underlying transactions in the funds. Therefore, the result is they are not able to accurately or consistently disclose relevant costs and charges to their clients from all parts of the value chain.

The table below summarises the extent to which the published disclosures by sell side firms in our sample addressed key pre-trade requirements. It also provides an overall rating based on the aggregate of their ratings across the four disclosures.

This shows that many banks are dealing to some extent with the high-level disclosures (disclosure of costs and charges amounts, and methodology), but do less well on the more specific information required (in relation to the breakdown of costs and charges and, in particular, the illustrations with the required features).

Where banks provide the amount for costs and charges, they are either disclosed as a fixed cash figure, range, or maximum amount. Where a fixed cash figure is provided it is based on an example trade of a specified product and size. 50% of the firms reviewed provide trade examples to demonstrate the typical costs and charges for a particular product.

The majority of firms do not provide an illustration of the impact of costs and charges on returns. One driver of this may be that this requirement does not appear directly relevant or meaningful for many capital markets activities and clients, and appears more relevant for asset and wealth managers providing ongoing services in particular to retail clients.

	Low levels of transparency	Partial levels of transparency	High levels of transparency
Presenting costs and charges amount as a percentage and cash amount	29%	36%	36%
Disclosure of methodology to costs and charges	21%	36%	43%
Breakdown costs and charges into categories of financial instrument, investment/ancillary service, and payments received from 3rd party	25%	57%	18%
Illustration providing (a) effect of costs and charges on return, (b) effect of spikes/fluctuations, and (c) description of illustration.	79%	18%	4%
Aggregated rating	29%	64%	7%

Where firms have landed and unintended consequences

Methodologies

Firms do not always explain how costs and charges are calculated (and not obliged to do so, as long as they provide disclosure of what the level of costs and charges will be). Based on firms which have explained their approach, we have observed the following:

- One widely used definition of costs and charges is the difference between the price at which the trade is executed with the client and a reference price, which may be a mid-market price or "fair value" price.

- Another definition commonly used is the level of markup, also described as the difference between the price at which the trade is executed with the client and the cost to the investment firm.

- For business which is conducted on the basis of fees or commission, those amounts are sometimes used as the costs and charges amount.

- A smaller number of firms also use other elements such as sales credit/margin, the interest/financing rate for repo transactions and equity swap transactions, and a flat fee based on the product type. 15% of the firms consider the price at which a trade is executed with a client as an all-in price, without any identification of an elements of costs and charges.

The use of different methodologies without a consistent framework across firms again limits the extent to which the costs and charges disclosures can be compared and therefore hinders increases in competition and transparency as intended by the regulator.

For many there is still much to do in 2018

The extensive book of work required to fully implement the costs and charges requirements, and associated change resource constraints in 2017, has led to a significant number of firms having to make prioritisation calls. This has led to firms implementing tactical solutions in 2017 with the intention of migrating to more sustainable approaches post go-live, and/or has led them to defer certain implementation activities to 2018 that do not materially impact their regulatory compliance.

With this in mind, it is our expectation that firms will need to continue to work on costs and charges requirements throughout 2018. Predominantly this will be to focus on the build out of the annual statement required for clients which was not required for 3 January 2018, reviewing approaches to calculations and disclosures in light of further regulatory guidance and industry norms, and enhancing systems, processes and associated controls.

Producing costs and charges annual statements

There is a requirement in the MiFID II text that requires investment firms to produce an annual statement of costs and charges, that shows the aggregate amount of costs and charges for the year. This aggregate amount is broken down into costs associated with financial instruments, costs associated with investment/ancillary services, and payments received from third parties.

As statements do not need to be provided to clients until the start of 2019, development of systems and processes has been postponed to 2018 by many firms. Firms are likely to build out this functionality in Q2 or Q3 of 2018 and will leverage costs and charges data that they should already be systematically capturing and providing to clients on a post-trade basis.

System enhancements

Due to the timeframe and other critical MiFID II requirements demanding prioritisation, some aspects of the costs and charges were implemented tactically. Firms have allocated 2018 to comply with pressing requirements that could not be delivered using automated solutions during the initial implementation.

For many banks system enhancements are likely to include:

- Automating processes that had to be implemented manually or via spreadsheets.
- Enhancing the calculation methodology and implementation to provide more meaningful costs and charges amounts in cases where the original methodology relied on overly simplified assumptions.
- Integrating costs and charges calculations, capture, and reporting from disparate systems across businesses into a more centralised infrastructure.

For many there is still much to do in 2018

Processes and controls

Whilst the focus has been on getting across the line in a compliant way, streamlining or automating processes and controls has been a secondary objective and something a number of firms did not focus on in 2017.

Now that firms have more bandwidth, many are planning to invest time streamlining processes where they cannot be automated as well as ensuring policies and procedures are documented. This will include implementing the right control and governance framework to ensure that disclosures are being made in line with the agreed method and that potentially reputation-damaging client or non-compliance errors are being flagged and escalated. This investment in robust controls and processes will in turn help ensure that costs and charges data being used to support other MiFID II requirements, such as best execution disclosures and client reporting requirements, is complete and accurate.

Review approach to calculation and disclosure

Given the uncertainty and lack of clarity on interpretation of requirements, a number of firms plan to step back and evaluate what they have implemented. This will help them assess their own regulatory status in anticipation of potential challenge from their regulators or their own clients.

Predominantly they will use two sources of information to do this. Firstly disclosures issued by investment firms are becoming more public, and therefore firms are able to review the various approaches being taken to inform them on their own approaches, both in terms of methodology used and the level of transparency. Some firms may seek to differentiate themselves on the transparency they provide, while others may be content to be in the “middle of the pack”, or to provide a lower level of disclosure. More available information can only aid this process.

Secondly it is envisaged that more guidance will be provided by regulators regarding the format of costs and charges disclosure, which would enable disclosures across the industry to be more aligned, and provide more meaningful and comparable data to investors.

Whatever changes are implemented will need to consider the impact of Brexit on planned changes to the operating and booking models.

Impact on the industry – will the new regime result in a better deal for clients?

The regulatory requirement for costs and charges transparency is intended to protect and strengthen the position of clients of investment firms. The increased transparency should allow clients to be better informed when selecting and dealing with firms, and ultimately result in downward pressure on the charges which they pay.

For asset managers, in particular, the requirement to provide transaction cost information is expected to have a significant impact. Transaction costs impact the performance of a fund, but until now their effect has not been transparent or analysed compared to the information provided about management fees and other expenses.

However, at this stage, the extent to which the new requirements are achieving their regulatory objective is not clear. There are a number of potential reasons for this which are explained below.

Lack of comparability

As highlighted in previous sections, one key challenge clients face in using the information is the lack of standardisation, which means that clients cannot make meaningful comparisons. This situation is likely to improve with time, as a result both of firms converging as they have access to each other's disclosures and of any regulatory guidance or standards emerging in the coming months and years. We understand that European and national authorities will issue further guidance later in 2018 once they have had the opportunity to assess the impact of the new requirements.

Client's primary focus is on total consideration

For sell side firms, many trades have been done, and continue to be done, primarily on the basis of an "all-in" price, rather than on the basis of clients reviewing an execution price for the financial instrument and then a separate fee or commission. The overall price is likely to remain a key consideration when clients are selecting and dealing with firms. These firms are therefore less likely to see major impact from the new transparency requirements regardless of what their disclosures state so long as overall price remains competitive. This may be a driver as to why certain sell side firms who predominantly trade with professional or other eligible counterparties haven't been particularly transparent or why the costs and charges calculation could be deemed as a regulatory formality.

Clients need to have size, appropriate skills and knowledge to analyse and make use of the information

As always, it will be the larger and more sophisticated clients who will be able to make effective use of the information provided. Clients who are not in a position to understand the information, or who have limited choice and negotiating leverage to make use of it, are likely to see fewer benefits arising from the new regime.

How we can help

Any impact on client relationships and regulatory compliance for investment firms will be dependent on how they choose to approach the challenges described in this paper. Firms that are willing to consider the long term, strategic view and evaluate the implications of costs and charges across their entire front to back operations, their client base and their product and service offerings will be better able to position themselves optimally in areas where their capabilities and resources allow them to use the regulations to build a competitive advantage.

Specifically PwC can support you with your strategic decisions around costs and charges by:

- Reviewing or refining calculation approaches.
- Benchmarking you against your industry peers.
- Aiding in developing a governance framework, a suite of controls, and MI reporting to ensure the correct costs and charges are being disclosed.
- Using our relationships with ESMA and regulators to provide insights into what regulators across the EU are expecting.
- Reviewing your organisational structure and target operating models to ensure it will deliver.

PwC have helped a number of European firms develop their MIFD II programmes and specifically support them with strategic decisions around costs and charges and the challenges they face. This has been done collaboratively, considering both the business strategy and the competitor environment. We are therefore well positioned to support you.

We have helped investment firms define costs and charges methodologies, drafted client communications and associated costs and charges policies, helped define and build system and supporting client portals, and set out new frameworks and operating models.

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