MiFID II review of services provided to professional clients and ECPs in 2018 and 2019

Findings and observations on cost transparency, product governance and inducements

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Dutch Authority for the Financial Markets (AFM)

The AFM is committed to promoting fair and transparent financial markets.

As an independent conduct supervisor, we contribute to sustainable financial well-being in the Netherlands.

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1. Introduction

In 2018 and 2019, the Dutch Authority for the Financial Markets (**AFM**) carried out a review of compliance with the obligations under MiFID II[1] in relation to cost transparency, product governance and inducements at 10 investment firms that provide investment services to exclusively professional clients and eligible counterparties (**ECPs**). Investment firms here also include banks and managers of alternative investment funds and UCITS that provide investment services to professional clients and ECPs[2].

One of the aims of MiFID II is to increase investor protection, not only for retail clients, but also for professional clients and ECPs. MiFID II has tightened and added to the rules for investor protection in many areas. The AFM wishes to stress that compliance with the new and tighter obligations under MiFID II calls for serious commitment on the part of investment firms. The AFM has therefore chosen to conduct a review of compliance with these obligations at an early stage.

The review reveals that diligent compliance with this regulation presents major challenges. The investment firms reviewed still need to take the necessary steps to comply fully with the obligations in relation to the three areas reviewed.

The AFM welcomes the fact that the investment firms it has reviewed have started to implement improvements in their organisation using the guidance offered by the AFM. Where relevant, the AFM expects investment firms not included in the review to implement improvements in their organisations on the basis of the contents of this report. It also expects investment firms to assess whether the findings are relevant for compliance with the obligations relating to other matters covered by MiFID II.

Structure of the report

This report begins with a description of the background to the review, and then its structure. The AFM then lists the review findings in relation to the 10 selected investment firms, followed by a detailed consideration of various observations as a result of the review and an account of its opinion with respect to these observations. Finally, the AFM explains what it expects of investment firms that provide investment services to professional clients and ECPs.

[1] Directive 2014/65/EU.

[2] The size of the total population of investment firms that exclusively provide investment services to professional clients and ECPs is determined on the basis of data from the Market Monitor (the AFM's periodic survey of investment firms).

2. Background to the review

MiFID II has tightened and added to the rules for investor protection in many areas. Although in many cases less onerous requirements apply for services to professional clients and ECPs (with the least onerous requirements applying to the latter), MiFID II is explicitly aimed at increasing investor protection for all client types. Accordingly, in 2018 and 2019 the AFM carried out various reviews of compliance with MiFID II, including attention to services provided to both retail clients and professional clients and ECPs.

For its review of investment firms providing services exclusively to professional clients and ECPs, the AFM decided to concentrate on three issues relating to investor protection. The AFM had previously announced that cost transparency and product governance would be priorities in its supervision of compliance with MiFID II in 2018. The AFM moreover expected the new rules on inducements (including for investment research) to materially affect the organisation and service provision of investment firms.

The key objectives of the review were:

i. establishing how and the extent to which the 10 investment firms reviewed have implemented the MiFID II provisions applying to them in relation to cost transparency, product governance and inducements; and
ii. identifying questions regarding the interpretation of requirements and practical difficulties encountered by investment firms in the implementation of the MiFID II obligations in these areas.

A brief explanation of these three areas is provided below. The AFM wishes to stress that MiFID II also covers other important areas to which the AFM will continue to devote attention in its ongoing supervision. A summary of these various areas, including a document listing the most important changes under MiFID II, is provided on the AFM's website.[3]

2.1 Cost transparency

Under MiFID II, all costs and charges of investment services, ancillary services and financial instruments must be disclosed prior to, during and after completion of the service provided. Since the client understands the overall cost and the cumulative effect on the return, it is in a better position to compare the costs of various types of services and financial instruments, and therefore make better-informed investment decisions.

This review has considered only compliance with the ex-ante cost transparency obligation. The ex-post cost transparency obligation was (in principle) not yet applicable during the review period and has therefore been left out of consideration.

[3] Available at https://www.afm.nl/nl-nl/professionals/onderwerpen/mifid-2/beleggersbescherming-wijzigingen.

2.2 Product governance

The rules for product governance apply to both manufacturers and distributors of financial instruments.[4] One important aspect of the rules concerns the identification of the appropriate target market and the related distribution strategy for all the financial instruments offered. These rules should ensure that investment act in their clients' best interests in the development and distribution of a financial instrument. For the purposes of this review, the AFM has restricted itself to the product governance requirements applying to distributors.

2.3 Inducements

A ban on the receipt or payment of inducements from or to third parties in relation to the provision of services to retail clients has applied in the Netherlands since 1 January 2014. MiFID II also introduces strict rules in relation to inducements for services to professional clients, in particular for portfolio management and independent investment advice. These rules also apply to investment research. In the provision of portfolio management and independent investment advice, no investment research may be obtained from third parties without this being paid for. For this review, the AFM has assessed only policy documentation and procedures relating to inducements. Implementation in practice has in principle not been reviewed.[5]

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[4] The legislation and regulation uses the term 'investment product', since the product governance requirements apply to structured deposits as well as financial instruments. Because this review did not consider structured deposits, we have decided to use the term 'financial instruments'.

[5] The AFM has, however, requested contracts for the receipt of investment research from third parties so that it could establish that an investment firm had paid for investment research from a third party, without making any judgement regarding the amount paid. In its assessment of the requirements for a separate research payment account, the AFM also assessed underlying documentation, such as the substantiation of research budgets.

3. Structure of the review

The AFM selected 10 investment firms for this review of different sizes and offering different types of services. This selection was not a representative sample. However, various types of services fall within the scope of the review. The AFM has accordingly obtained, a broad view of the implementation of the MiFID II rules in practice with a wide range of observations

The review period was the period from the introduction of MiFID II on 3 January 2018 until the date on which the investment firms responded to the request for information (the beginning of July 2018).

As part of the review, the AFM requested information from the selected investment firms and held an interview with each of them. During the interviews, the AFM put questions to the investment firms about the information they had provided and shared its provisional findings. The review focused on both the documentation and implementation of policy.

To ensure consistency in its assessment, the AFM developed a framework of rules for its assessment of each topic. The AFM based its formulation of these frameworks on the relevant provisions in national and European legislation and regulation. For the issue of product governance, it also included the ESMA Guidelines on MiFID II product governance requirements (**ESMA Guidelines**).[6] The AFM applies the ESMA Guidelines in its supervision of compliance with the product governance requirements. For the topics of cost transparency and inducements, the AFM also included the further explanation provided by ESMA in the Q&A on investor protection issues in MIFID II and MiFIR (**ESMA Q&A**)[7].

The rules frameworks are listed in the appendix to this report. The AFM wishes to stress that these frameworks are intended for use with respect to service provision to professional clients and ECPs, and not for service provision to retail clients.

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[6] See https://www.esma.europa.eu/sites/default/files/library/esma35-43-620_guidelines_on_mifid_ii_product_governance_requirements_0.pdf.
[7] See https://www.esma.europa.eu/press-news/esma-news/esma-updates-mifid-ii-mifir-investor-protection-qa.

4. Findings

The review shows that the investment firms reviewed still need to take the necessary steps to comply fully with the obligations relating to the three topics reviewed. It is clear that full and diligent compliance with the new regulation presents serious challenges.

In particular, several investment firms took the view that they should be able to apply the new obligations proportionally, particularly with respect to the topics of cost transparency and product governance. They relied for instance on current measures and procedures as prescribed under MiFID I[8] without taking (sufficient) additional measures to comply with the stricter requirements in MiFID II.

For example, some investment firms took the view that the cost reports that they were providing to clients before MiFID II came into effect provided adequate information for clients and that no additional measures were therefore necessary. These reports, however, did not meet the requirements under MiFID II with respect to cost disclosure. Investment firms also referred to existing measures and procedures regarding the suitability requirements in order to demonstrate that they were in compliance with the product governance requirements.

The AFM stresses that MiFID II contains many new and stricter obligations, also with respect to the provision of services to professional clients and ECPs. Compliance with these obligations demands a serious effort from investment firms and these obligations cannot be met by complying with the existing obligations under MiFID I. The AFM urges all investment firms to improve their procedures and measures where necessary in order to be able to comply with the prevailing rules in the future.

The specific review findings for each issue are listed below. In this section, the AFM has not included references to specific articles of the legislation. The full rules frameworks are provided in the appendix.

4.1 Cost transparency

The review showed that compliance with the rules on cost transparency can be improved. Still, the findings at the investment firms were very diverse. They can be roughly divided into three groups.

The first group had provided information on costs prior to providing the investment service (investment advice or execution-only[9]), but this information did not meet all the requirements under MiFID II. Examples are:

- costs were expressed solely as a percentage or an amount, instead of both a percentage and an amount;
- costs of financial instruments were not reported, also not as '0' if this was the case;
- there was no aggregation of the costs;

[8] Directive 2004/39/EC.
[9] This term refers to the provision of investment services and the reception and transmission and execution of client orders.

- if costs were paid in a foreign currency, there was no indication of the currency, its applicable conversion rates and costs;
- there was no illustration of the cumulative effect of the costs on the return.

Moreover, in many cases it was not clear whether actually all the costs had been stated, since the investment firms were not able to provide the AFM with details of their underlying calculations. The AFM could for instance not establish that the implicit transaction costs, or the costs incurred within an alternative investment fund or UCITS, were calculated correctly.

The second group of investment firms did not provide any information on costs to the client prior to provision of the investment service (investment advice or execution-only).

Finally, there was a third group indicated that they did not yet have to comply with the cost transparency obligations, since they had not provided any (new) investment services during the review period. The AFM nevertheless advised these investment firms that they needed to comply with the cost transparency obligations in the future. Based on the available procedures and measures, the AFM could establish that the working practices at these investment firms would not be adequate for them to be able to meet the cost transparency obligations in the future.

4.2 Product governance

The AFM also concluded that improvement was needed with respect to compliance with the product governance requirements. Here too, there was wide variation. Again, the investment firms could be divided roughly into three groups.

The first group did have procedures and measures for product governance in place, and had determined the target market for five financial instruments selected by the AFM. These documents were, however, not sufficiently detailed. For instance, it was not possible to derive from the procedures and measures how the investment firm had identified the target market. For instance, there was no clear definition of the criteria used by the investment firm for each target market category. The description of the target market was also not sufficiently detailed and was not specific enough. In cases where the investment firm defined a target market for a cluster of financial instruments, there was no account of how the clusters had been formulated.

The second group also had insufficiently detailed procedures and measures, and moreover had not defined any target market for the financial instruments selected by the AFM. In other words, the procedures and measures were not applied in practice.

The third group did not have any procedures and measures in place, and also had not defined a target market for the financial instruments selected by the AFM. These investment firms took the view that they did not qualify as distributors, since in their opinion the provision of portfolio management or the reception and transmission of orders did not involve the distribution of financial instruments.

The AFM wishes to emphasise that this opinion is not correct. The term 'distributor' has to be widely interpreted and in any case includes the investment services of reception and transmission of orders, order execution, portfolio management and investment advice.

4.3 Inducements

Virtually none of the investment firms in the review stated that they received inducements from third parties in relation to the provision of investment or ancillary services. With respect to monetary fees and commissions, this is shown in their procedures and measures in most cases.

At the same time, almost all the investment firms stated that they received minor non-monetary benefits (**MNMB**) from third parties in relation to the service provision. The AFM accordingly notes that these investment firms have incorrectly concluded that they have not received inducements from third parties, since MNMB also qualify as inducements.

The review also revealed that the definition of MNMB applied by many investment firms in their policies is wider than the definition given in Article 12(3) of the Delegated Directive[10] (**DD**). This means that these investment firms are able to receive benefits that are not permitted since they do not fall within the definition in this Article.[11] The AFM stresses that the list of MNMB in Article 12(3) DD is exhaustive and that there is no possibility for an investment firm to qualify other non-monetary benefits as MNMB.

For these investment firms, the AFM has therefore concluded that they do not have an adequate policy in place to sufficiently ensure that the rules on inducements are observed.

The review also showed that the investment firms receiving non-monetary benefits in relation to execution-only services do not test all benefits against the criteria stated in Article 168aa(5) of the Decree on Conduct of Business Supervision of Financial Undertakings under the Wft (Besluit Gedragstoezicht financiële ondernemingen Wft, or **BGfo**). This chiefly concerns business gifts.

The AFM additionally assessed the receipt of investment research from third parties. This produced the following findings:

- All the investment firms receiving investment research from third parties paid for this investment research, either from their own resources or from monies paid by clients into a separate research payment account.
- Most of the investment firms had also instituted a process to prevent research being received that is not paid for. Various investment firms had informed all their employees regarding the rules governing the receipt of material from third parties and instituted a process whereby employees have to refer cases involving doubt to the compliance department. These investment firms had also issued a list of contracted research providers to their employees.

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[10]Delegated Directive (EU) no. 2017/593 of the European Commission of 7 April 2016. Article 12(3) DD is implemented in Article 168aa(2) of the Decree on Conduct of Business Supervision of Financial Undertakings under the Wft (BGfo) via a dynamic reference.
[11] This Article is implemented in Section 168aa (2) BGfo via a dynamic reference.

- At the same time, there was not always enough attention paid to oral information received by investment firms from third parties, for example in the form of what are known as 'morning calls', in which brokers provide an overview of the relevant developments for the coming trading day. Investment firms also have to assess whether this oral information constitutes research or MNMB.
- Furthermore, some investment firms used a narrower definition of investment research than the description provided in Recital 28 DD. This may lead to a situation in which the investment firms concerned receive research from third parties without paying for it.
- Lastly, the investment firms with separate research payment accounts did not comply with all the requirements pursuant to Article 168aa(7) BGfo in conjunction with Article 13 DD that apply to such separate research payment accounts. The main deficiencies were the absence or inadequacy of supporting information for the research budgets referred to in Article 13(1) (b)(ii) DD and the lack of detail with regard to the robust quality criteria referred to in Article 13(1) (b) (iv) DD to enable assessment of the investment research purchased.

5. Selected observations

This section presents various observations from the review selected by the AFM and states the AFM's position in each case, as the AFM believes that this may be relevant for the entire population of investment firms. While parts of the rules frameworks used in the review are mentioned in this section, this is not a full account of the rules tested. The full rules frameworks are listed in the appendix.

5.1 General: investment services in the context of fiduciary management

Situation. Several investment firms in the review offer fiduciary management to their clients, in most cases pension funds. Fiduciary management covers services ranging from services that do not qualify as investment services (such as advice on strategic asset allocation) to services that do qualify as investment services. These include portfolio management, investment advice and the reception and transmission of orders in relation to financial instruments.

The review shows that the investment firms qualify the services they offer as part of fiduciary management in various ways, although the services they provide are similar in nature. The fiduciary management offered by most investment firms includes a combination of portfolio management, investment advice and the reception and transmission of orders. One firm, however, states that fiduciary management involves only portfolio management, or portfolio management and investment advice.

Position of the AFM. Under Article 2:96(1) of the Financial Supervision Act (Wet op het financieel toezicht, or **Wft**), the provision of investment services or performance of investment activities is forbidden without obtaining a licence for this from the AFM. The definition of the provision of an investment service is given in Article 1:1 Wft. This includes the provision of the services portfolio management, investment advice, order execution and reception and transmission of orders.

When an investment firm provides fiduciary management, involving a combination of the investment services portfolio management, investment advice and reception and transmission or execution of orders, the AFM takes the position that they need to obtain a licence for the provision of all these separate services.

Unlike investment advice, portfolio management involves a discretionary authorisation for the investment firm to take decisions with respect to financial instruments on the client's behalf within the investment guidelines agreed with the client. In other words, the client does not have to give permission for each transaction before such investment decisions are made. In the case of investment advice, the role of the investment firm is limited to advice on financial instruments, with the client making the final investment decision. Finally, carrying out an investment decision by the client with respect to a financial instrument, depending on the exact role of the investment firm, qualifies as reception and transmission or execution of orders.

It follows therefore that an investment firm which in the context of the provision of fiduciary management is not itself authorised in all cases to make an investment decision, but which also makes specific proposals to the client with respect to specific financial instruments, will need a licence for both the provision of portfolio management and a licence for the provision of investment advice. If the investment firm is also authorised to implement the client's investment decisions, whether based on proposals made to the client or not, it will also need a licence for the reception and transmission or execution of orders.

5.2 Cost transparency

On 17 July 2019, ESMA published a 'Call for evidence' inviting all stakeholders to respond to a number of questions it posed in this document, including with respect to the issue of cost transparency. The responses to this Call for evidence are published on the ESMA website[12]. It is very possible that the obligation to provide ex-ante cost information to professional clients and ECPs will be changed as a result of this consultation. This could affect the situations and positions of the AFM described below.

5.2.1 Provision of information in a durable medium for telephone orders

Situation. Investment firms that offer execution-only services to professional clients and ECPs state that it is difficult or impossible for certain types of orders to comply with the obligation to provide information on costs in a durable medium prior to the provision of the service without this interfering with the interests of the client. This involves a service in which the client issues an order by telephone and it is important that the order is executed immediately.

The investment firms concerned state that providing cost information in a durable medium before the order is executed delays the transaction and thus can harm the client's interests. This delay may of course mean that the price of the financial instrument changes. The investment firms concerned have accordingly adopted a different solution. For instance, they provide the information for each separate transaction only orally by telephone.

Position of the AFM. Under Article 58(1) BGfo in conjunction with Article 46(2) and (3) of the Delegated Regulation MiFID II (**DR**)[13] an investment firm has to provide information on all costs in a durable medium to the client in good time prior to the provision of the service. A letter, e-mail or a chat system that enables clients to save the chats (such as *Bloomberg message*) qualifies as a durable medium. The information may also be provided on a website, subject to the conditions of Article 3 (2) DR being met. A telephone conversation is not a durable medium, even if it is recorded.

The AFM wishes to stress that an investment firm must at all times provide information on all costs in a durable medium in good time prior to provision of the service. The client must be able to refer to the information on costs at a later stage. Only providing information on costs orally by telephone therefore does not meet the requirement of Article 46(3) DR.

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[12] See https://www.esma.europa.eu/press-news/consultations/call-evidence-impact-inducements-and-costs-and-charges-disclosure
[13] Delegated Regulation (EU) 2017/565 of 25 April 2016.

The AFM is aware that this obligation may conflict with the nature of certain types of execution-only services to professional clients and ECPs. We refer in this respect to Q&A 9.28 of ESMA, published on 29 May 2019. In this Q&A, ESMA states, in summary, that investment firms may use the following approach in such situations. Firstly, the client must be offered the possibility of delaying the transaction so that they have the opportunity to review the cost information. If the client states that the speed with which the transaction can be executed is a priority, the investment firm must provide the cost information orally by telephone prior to execution of the transaction and at the same time provide the information to the client in a durable medium.

Another possibility is described in Q&A 9.23 of ESMA. This Q&A concerns only a situation in which there are no costs involved for the financial instrument. In Q&A 9.23, ESMA states that for the provision of ex-ante cost information and subject to strict conditions, a table of costs can be provided on one occasion instead of prior to each separate transaction.

5.2.2 Ongoing relationship

Situation. Some investment firms state that in their view, an execution-only service to ECPs will rarely involve an ongoing relationship. In their opinion, the existence of a contract between the investment firm and the client whereby the client has a trading account they use for trading is not in itself sufficient to qualify a situation as one of an ongoing relationship. According to these investment firms, the transactions the client effects have to be in connection with each other in order for the situation to qualify as an ongoing relationship. As such, a situation in which a client has a trading account with an investment firm and effects multiple transactions in the course of a year that are not related to each other would not qualify as an ongoing relationship and therefore Article 50(9) DR would not apply.

Position of the AFM. Under Article 50(9) DR, an investment firm that recommends or markets financial instruments to clients with whom it has an ongoing relationship must provide information at least once a year on a personalised basis on the actual costs of the services and the financial instrument.

ESMA has clarified the definition of an ongoing relationship in Q&A 15.1. In general, ESMA makes it clear that one has to consider the meaning of the term itself, in other words, cases in which an ongoing relationship with a client exists or has existed during the past year. ESMA states a number of non-exhaustive examples of situations involving an ongoing relationship. One of these is the existence of a contract between the investment firm and the client whereby the client has a trading account they use for trading.

The AFM stresses that the position of the investment firms mentioned above is not in line with ESMA Q&A 15.1. Whether there is a connection between the various transactions effected in a trading account or not is not an issue in the qualification of an ongoing relationship. The existence of a contract between the investment firm and the client whereby the client has a trading account they use for trading is sufficient.

In this respect, the AFM refers also to the principle behind the obligation under Article 50(9) DR. The client must be given the opportunity to understand and compare the overall cost of the service and the financial instrument during the course of a year. If the client has effected two or more transactions during a year, the AFM takes the view that offering an ex-post cost summary would add value for the client.

5.2.3 Limited application of cost transparency rules

Situation. Various investment firms, also those providing portfolio management and/or investment advice to professional clients, invoke the right to agree to a limited application of the detailed requirements under Article 50 DR. For instance, they do not provide the illustration of the cumulative effect of the costs on the return.

Position of the AFM. The rules for cost transparency apply to all types of service provision and all types of client. In principle, there is no provision for proportional interpretation.

On the basis of Article 50(1) DR, investment firms are, however, entitled to agree on a limited application of the detailed requirements under Article 50 DR with a professional client or ECP. This means that in the provision of services to professional clients and ECPs, investment firms must always comply with the obligations set out in Article 24(4) MiFID II, but may omit certain specific requirements of Article 50 DR, such as the provision of an illustration of the cumulative effect of costs on return, subject to this having been agreed.

Article 50(1) DR, however, states that this limited application may not be agreed with a professional client or ECP in all cases. Investment firms are not allowed to agree such limitations with professional clients when providing investment advice or portfolio management services or when, irrespective of the investment service provided, the financial instruments concerned embed a derivative.

Limited application may not be agreed with ECPs in cases where the financial instruments concerned embed a derivative and the ECP intends to offer them to its clients.

Article 50(1) DR states that investment firms providing execution-only services and wishing to make use of a limited application of this Article must have agreed with the client what obligations under Article 50 may be omitted. Q&A 9.18 of ESMA further explains that an investment firm may only use limited application of Article 50 DR where it has an agreement with the client. This implies that the client must have given explicit permission to the investment firm to omit certain specific provisions of Article 50 DR. The inclusion of this information in general terms and conditions, or the assumption of a tacit permission, is therefore not sufficient.

The AFM further stresses that an investment firm must at all times comply with the overall cost transparency obligations as stated in Article 24(4) MiFID II, as implemented in Article 4:20(1) Wft and Article 58 BGfo. No limited application may be agreed for these obligations.

5.2.4 Transaction costs: costs of service provision *or* costs of financial instrument?

Situation. The review shows that investment firms qualify the same costs differently. There is for example a lack of clarity as to whether the costs of entering or exiting an alternative investment fund or UCITS (in this case, what are known as anti-dilution levies) should be qualified as costs of the financial instrument or as costs of the service.

Another example concerns the costs for non-exchange traded derivatives such as interest rate swaps. The costs for transactions in these financial instruments are included in the spread between the purchase and the sale price, and there may be additional costs as well. Some investment firms qualify costs included in the spread as costs of the financial instrument, others qualify these as costs of the service.

Position of the AFM. Under Article 58(4) BGfo in conjunction with Article 50(2) DR, an investment firm shall aggregate the information on all costs in connection with the service and the financial instrument so that the client understands the overall cost as well as the cumulative effect of these costs on the return of the investment. If the client so requests, an itemised breakdown shall be provided at the least at the level of the cost types as listed in tables I and II in Appendix II, DR.

These tables show which cost items are related to the provision of the service and which cost items relate to the financial instrument. This ensures that cost items of the same type are qualified as such.

Depending on their nature, transaction costs may be qualified as costs of the service or costs of the financial instrument. Transaction costs for the purchase or sale of a financial instrument should be qualified as costs of the service.

On the other hand, there are transaction costs that are incurred within the financial instrument. These may concern the transaction costs incurred within an alternative investment fund or UCITS as a result of the conduct of the investment policy, separate from the transaction costs incurred for the purchase or sale of assets as a result of the entry or exit of specific investors.

The rules for cost transparency are designed to enable clients to understand all the costs of the financial instrument and the service and to compare the costs between different investment firms. This is why it is important that costs of the same type are qualified as such. In the opinion of the AFM, there is no lack of clarity with respect to the entry and exit costs for the purchase or sale of a unit of participation in a collective investment scheme. These costs qualify as costs of the service, regardless of whether they are paid to the investment firm or UCITS or to the manager concerned.

The AFM acknowledges that there may be categories of financial instruments for which it is less clear whether certain costs should be qualified as costs of the financial instrument or as costs of the service, for example the spread charged for non-exchange-traded derivatives. It can be argued that these costs do not include only transaction costs, meaning the costs incurred for the purchase

or sale of the derivative, but that they also include the costs involved in the structuring or 'creation' of the derivative.

For a consistent approach in the market, the AFM considers it desirable that investment firms qualify the costs of derivatives in a uniform manner.

5.2.5 Referral to or recommendation of other portfolio managers

Situation. Investment firms providing portfolio management or investment advice to professional clients frequently also provide advice on having a portion of the client's portfolio invested with another portfolio manager. In some cases, a comparison is made between having a portion of the portfolio managed by another portfolio manager or investing that portion of the portfolio in a collective investment scheme. Recommending another portfolio manager does not qualify as investment advice. The obligation applying to these investment firms under the cost transparency rules is not entirely clear at this time.

Position of the AFM. Under Article 50(7) DR, an investment firm that recommends or markets services provided by another firm to its client, or refers its client to another firm, shall aggregate the costs of these services with the costs of its own services.

Although referral to other portfolio managers does not qualify as an investment service, under Article 50(7) DR the investment firm must state the costs of the services of the other portfolio manager by aggregating these costs with the costs of its own service.

The AFM believes that it is an example of good practice to also state the costs of the financial instruments in which the other portfolio manager invests, so that the client can compare the costs of the different investment proposals and has a full picture of all the costs involved.

5.2.6 Definition of transaction costs

Situation. The review revealed that it is not always entirely clear what is covered by the term 'transaction costs', as referred to in Article 50 and tables I and II of Annex II DR. Certain types of investment may for example involve costs of translation, or costs for due diligence investigations, before a transaction can be effected.

Position of the AFM. The cost items that an investment firm has to disclose under Article 50 DR include transaction costs. The definition in table I of Annex II DR is as follows: all costs related to transactions initiated in the course of the provision of an investment service.

The AFM stresses that the term 'transaction costs' should be broadly interpreted, as also stated in table I of Annex II DR. Transaction costs are all the costs resulting from the execution or reception and transmission of orders in financial instruments, and that are directly or indirectly charged to the client. Besides the more usual transaction costs such as broker commissions, bid-ask spreads and transaction taxes, the term also covers less usual costs such as the costs of a legal opinion or a due diligence investigation, if these costs are the result of transactions in financial instruments that are initiated in the course of the provision of an investment service.

5.2.7 Ex-post cost transparency obligation in relation to periodic portfolio management reporting

Situation. Several investment firms were under the impression that the periodic reports as referred to in Article 60 DR that they send to their clients as part of the provision of a portfolio management service qualify as ex-post cost statements as referred to in Article 50(9) DR.

Position of the AFM. Under Article 50(9) DR, an investment firm that recommends or markets financial instruments to clients with whom it has an ongoing relationship must provide information at least once a year on a personalised basis on the actual costs of the services and the financial instrument.

Under Article 60 DR, an investment firm that provides the service of portfolio management to clients shall provide each client with a periodic statement of, among other things, the total amount of fees and charges incurred during the reporting period itemising at least total management fees and the total costs associated with execution, and including, where relevant, a statement that a more detailed breakdown will be provided on request.

The AFM stresses that the periodic reports that have to be sent to clients taking portfolio management services under Article 60 DR are not the same as the reports that have to be provided to clients under Article 50(9) DR. These involve different content, a different method of presentation and a different period to which the cost statement relates. In cases where the investment firm provides a portfolio management service, it must provide both these reports. The ex-post cost statement as referred to in Article 50(9) DR may be provided together with the existing periodic report to the client.

5.3 Product governance

5.3.1 Qualification as distributor

Situation. Some investment firms providing the investment services of portfolio management, reception and transmission of orders or order execution were of the opinion that they do not qualify as a distributor and therefore were not obliged to comply with the product governance requirements applying to distributors.

Position of the AFM. Investment firms that distribute financial instruments have to comply with the product governance requirements for distributors as stated in Article 32b BGfo. In summary, a distributor must have procedures and measures in place that ensure that a target market and related distribution strategy is defined for all the financial instruments that may be distributed and that ensure that the financial instruments are evaluated on a continuous basis. The product governance requirements are designed to ensure that financial instruments are distributed to an appropriate target market. This reduces the risk of mis-selling.

Recital 15 DD clearly states that an investment firm that offers or sells financial instruments to clients qualifies as a distributor. It makes no difference whether these services are provided to retail clients, professional clients or ECPs.

The AFM stresses that the term 'distributor' should be broadly interpreted, and at the least includes an investment firm that provides the investment services of reception and transmission of orders, order execution, portfolio management or investment advice. An investment firm that provides portfolio management services to professional clients, or an investment firm that provides execution-only services to professional clients and ECPs, therefore must comply with the product governance requirements for distributors.

5.3.2 Suitability requirements relating to product governance

Situation. Some portfolio managers argued that the institution of procedures and measures and the identification of target markets in relation to the product governance requirements would not add value, since the assessment of suitability already ensures that financial instruments end up with the right target market. There was also regular reference to the fact that they provide a service to professional clients, which involves an active relationship between them and their clients.

The AFM has moreover encountered an incorrect interpretation with respect to the provisions in relation to diversification and hedging in the context of product governance as stated in ESMA Guidelines 52 to 55. This interpretation was that these guidelines state that the suitability requirements prevail over the product governance requirements.

Position of the AFM. In the provision of portfolio management, an investment firm must comply with the requirements relating to the establishment of suitability (Article 4:23 Wft). Briefly, this requirement means that an investment firm must obtain information on the client's situation in order to establish whether the financial instruments or portfolio to be managed are suitable for the client. The definition of a target market cannot be replaced by the assessment of suitability or appropriateness (see the Explanatory Memorandum to the Decree on Implementation of the Markets in Financial Instruments Directive 2014 and ESMA Guideline 33[14]). The principle of proportionality does apply.

The AFM stresses that it attaches great value to the additional protection provided to clients by the product governance requirements, also for services provided to professional clients and ECPs. The term 'professional client' may cover a wide variety of clients. For example, the level of financial knowledge available at a relatively large or a relatively small pension fund may be very different. The product governance requirements ensure that before providing the service, investment firms consider the various types of client that they can serve and the appropriate product categories. An investment firm must take responsibility for the financial instruments that it can distribute, and therefore cannot use the wishes of the client as an excuse not to do so, even if the client is a professional client or an ECP. Assessment of suitability cannot replace compliance with the product governance requirements. The product governance requirements provide an additional safeguard

[14] ESMA Guidelines for product governance requirements under MiFID II, 5 February 2018 (ESMA35-43-620).

against the risk that financial instruments will be distributed to an inappropriate target market (mis-selling).

ESMA Guidelines 52 to 55 make it clear that a financial instrument may be distributed outside the identified target market in the provision of portfolio management or investment advice, as long as the portfolio as a whole or the combination of the hedge and the hedged financial instrument is appropriate for the client. If distribution is made outside the identified target market for reasons of diversification or hedging, this does not have to be reported to the manufacturer. The investment firm must in this case formulate and record its reasons for deviating from the identified target market. This possibility of deviation does not apply to distribution to the negative target market. The AFM stresses that the target market, also in the case of portfolio management or investment advice, should always be identified at the level of the financial instrument and not at the level of the client's portfolio.

5.3.3 Target market categories

Situation. Some investment firms did not include all five categories of target market in the ESMA Guidelines when identifying the target market for financial instruments. For instance, some investment firms providing portfolio management or investment advice consider only the target markets categories of client type and knowledge and experience, and do not use the categories of financial situation, risk tolerance and objectives and needs. According to these investment firms, these three categories do not have to be considered since these had already been addressed when assessing suitability.

Position of the AFM. Under Article 32b(6) BGfo and ESMA Guideline 27 to 29, an investment firm identifies the target market and the related distribution strategy for all financial instruments that it distributes or may distribute.

The ESMA Guidelines state that a distributor must always use at least the five target market categories when identifying the target market, regardless of the type of service or the type of client. The AFM stresses that the product governance requirements cannot be replaced by the suitability assessment and that they therefore provide additional protection for the client (see ESMA Guideline 14 and 16 and the note from ESMA in paragraph 20 of the background section of the ESMA Guidelines).

In the provision of portfolio management or investment advice, deviation from the identified target market is permitted for reasons of diversification or hedging, as long as the total portfolio or combination of the hedge with the hedged risk is appropriate for the client. This does not change the fact that the target market must always be identified at the level of the financial instrument. The exception in relation to diversification or hedging on the basis of ESMA Guideline 52 to 55 does not apply to execution-only services. Still, the AFM takes the view that an investment firm must also be able to deviate from certain target market categories, such as risk tolerance, in the case of execution-only services to professional clients and ECPs. But this is subject to the investment firm

having established that the professional client or ECP has sufficient knowledge and experience, and that the professional client actually has the objective of hedging.

5.3.4 Identifying the target market on the basis of a cluster of financial instruments

Situation. Several investment firms in the review had only identified the target market for certain product groups, or 'clusters', rather than for all the individual financial instruments they distribute. For instance, the cluster of 'hedge funds' or 'derivatives'.

Position of the AFM. Under Article 32b(6) BGfo and ESMA Guideline 27 to 29, an investment firm identifies the target market and the related distribution strategy for all financial instruments that it distributes or may distribute.

The investment firm may choose to identify a target market for each cluster of financial instruments rather than for each individual financial instrument. If so, the investment firm needs to ensure that the financial instruments in the separate clusters have enough features in common. Only then can it be guaranteed that the target market is appropriate for all the financial instruments in a cluster.

On this basis, one can say that identifying a target market for a cluster of 'hedge funds' or 'derivatives' is not adequate. After all, the cluster of 'hedge funds' could include hedge funds with very different investment strategies and fund conditions that may be appropriate for a different target market. The cluster of 'derivatives' may include various types of derivatives (such as options, futures and swaps) which in turn cover a variety of financial instruments. In its procedures and measures, an investment firm needs to state the basis on which it has formulated these clusters and demonstrate that the clusters it has formulated are in fact sufficiently homogeneous.

In addition, an investment firm identifying a target market on the basis of clusters must have a process for checking that all the financial instruments it distributes are actually appropriate for the clusters it has formulated. This could for instance involve checking that the credit risk of a particular bond fund is in line with the established credit risk for a specific cluster of bond funds, or that the costs of a particular bond fund are in line with the criteria set for this in the relevant cluster. An investment firm can thus ensure that a target market has been identified for all the financial instruments it distributes and that the financial instruments are distributed to the right target market.

5.4 Inducements

5.4.1 Definition of minor non-monetary benefits (MNMB)

Situation. Some investment firms in the review used a different and in some cases more extensive list of benefits that qualify as MNMB than the list in Article 12(3) DD. For example, they qualified software provided by a broker or a bottle of wine as MNMB. Several investment firms have a policy whereby they qualify non-monetary benefits that are not listed under Article 12(3) (a) to (d) as MNMB.

Position of the AFM. An investment firm should not receive any non-monetary benefits from third parties other than MNMB in relation to the provision of portfolio management or independent investment advice to a professional client. Article 12(3) DD contains an exhaustive list of benefits that qualify as MNMB.

The AFM stresses that the list of benefits included in Article 12(3) DD is exhaustive. Other benefits do not qualify as MNMB and therefore may not be received in relation to portfolio management or independent investment advice. Under Article 12(3) (e) DD, Member States have the option of qualifying non-monetary benefits not listed under (a) to (d) of this Article as MNMB, subject to certain conditions. An investment firm may, however, not make this qualification independently.

So, although the list of MNMB is exhaustive, an investment firm will have to make an interpretation of the benefits listed in Article 12(3) (a) to (d) DD. For example, it will have to make clear how it interprets 'information or documentation relating to a financial instrument or an investment service that is generic in nature or personalised to reflect the circumstances of an individual client', as stated in Article 12(3) (a) DD.

5.4.2 Business gifts from third parties in relation to an investment service

Situation. Various investment firms have a specific policy with respect to the receipt of business gifts from third parties in addition to their policy in relation to the receipt of inducements from third parties. This policy includes strict conditions in many cases, such as a ban on the receipt of business gifts in monetary form and not allowing receipt of gifts with a value of more than 100 euros per third party per year. However, the policy does not state that the receipt of business gifts in relation to an investment service will be checked to establish whether the gifts qualify as MNMB (for portfolio management and independent investment advice) or that they meet the requirements under Article 168aa(5) BGfo (for other investment services and ancillary services).

Position of the AFM. Different rules apply to the receipt of inducements from third parties with respect to the provision of investment or ancillary services to a professional client, depending on the investment service provided. Under Article 168aa(1) and (2) BGfo, inducements received from third parties in relation to the provision of portfolio management and independent investment advice to a professional client must be passed on in full if the fee or commission is in monetary form, and receipt of non-monetary benefits is not permitted unless these are MNMB.

Under Article 168aa(5) BGfo, inducements from third parties in relation to the provision of other investment services and ancillary services to a professional client may only be received if the following requirements are met: 1) the inducements must enhance the quality of the service as referred to in Article 11(2) and (4)DD, 2) the inducements may not lead to conflicts of interest and may not conflict with the investment firm's obligation to act in the best interests of the professional client, and 3) the professional client must be kept adequately informed with regard to the inducements.

The AFM stresses that business gifts qualify as inducements and investment firms must therefore comply with the applicable rules relating to inducements when accepting business gifts from third

parties in relation to the provision of an investment service. Since business gifts do not usually qualify as MNMB, in most cases they cannot be accepted in relation to the provision of portfolio management or independent investment advice to a professional client. In addition, in most cases involving receipt of business gifts in connection with the provision of other investment services or ancillary services to a professional client, it will not be possible to demonstrate that receipt of such gifts enhances the quality of the service provided to the client. Therefore, receipt of business gifts from third parties will in most cases not be permitted for these services as well.

The AFM stresses that the rules on inducements make no exceptions with respect to the receipt of benefits of low value, or with a value not exceeding (for example) 100 euros on an annual basis. Until the introduction of MiFID II, the ban on inducements for the provision of investment or ancillary services to retail clients included an exemption for business gifts with an aggregate annual value of 100 euros or less. This exception, which used to be included in the BGfo, has lapsed with the introduction of MiFID II.

5.4.3 Obligation to hold evidence with respect to MNMB

Situation. Several investment firms have a policy that they will accept only MNMB from third parties in relation to portfolio management or independent investment advice. However, these investments firms did not record the MNMB they had received from third parties, or how they assess whether a benefit qualifies as an MNMB. They therefore were not able to provide documentation showing that they had accepted only MNMB.

Position of the AFM. Under Article 168aa(2) BGfo, an investment firm should not receive any non-monetary benefits from third parties other than MNMB in relation to the provision of portfolio management or independent investment advice to a professional client.

An investment firm must clearly state what forms of MNMB it may receive from a third party in relation to the provision of portfolio management or independent investment advice to a professional client. These forms should correspond to the exhaustive list stated in Article 12(3) DD, and further elaborated in ESMA Q&A 7.6 to 7.9. An investment firm should also clearly state how it assesses whether an MNMB is reasonable and proportionate and of such a scale that it is unlikely that the firm's behaviour could be influenced in any way that is detrimental to the interests of the relevant client (see also ESMA Q&A 7.6).

Under Article 35(1) BGfo, the AFM expects an investment firm to keep a record of all MNMB it has received from third parties in relation to the provision of portfolio management or independent investment advice. For each MNMB accepted from a third party, the investment firm should clearly state how it has assessed that the benefit is reasonable and proportionate and of such a scale that it is unlikely that the firm's behaviour could be influenced in any way that is detrimental to the interests of the relevant client.

This record is necessary to ensure that only MNMB are accepted. It is important therefore that this record also shows why the acceptance of a particular benefit has been approved or not. In addition,

an investment firm must be able to demonstrate to the supervisor that it has acted in accordance with Article 168aa(2) BGfo.

5.4.4 Different inducement regimes for various investment services

Situation. Several investment firms provide multiple investment services or ancillary services to a client, for example portfolio management, investment advice and the reception and transmission of orders. Inducements from third parties are received in relation to these investment services. The investment firms concerned stated that it is difficult to determine the exact investment service for which these inducements are received. The question therefore is which inducement regime should these investment firms follow.

Position of the AFM. Different rules apply to the receipt of inducements from third parties with respect to the provision of investment or ancillary services to a professional client, depending on the investment service provided. These rules are explained in more detail under observation 5.4.2.

In its provision of investment services and ancillary services, an investment firm must comply with the applicable rules on inducements at all times. If in the case of provision of multiple investment services or ancillary services to a client it is not possible to establish with certainty the specific investment service or ancillary service for which an inducement is received, the AFM takes the view that the investment firm should comply with the strictest inducement regime. This means that the firm must follow the regime applying to the receipt of inducements in relation to the provision of portfolio management or independent investment advice.

5.4.5 Definition of investment research

Situation. Several investment firms used a different definition of investment research in their procedures and measures, limiting their definition to material relating to financial instruments. This suggests that in their opinion, material relating to private equity or real estate for instance does not qualify as investment research.

Position of the AFM. Under Article 168aa(7) BGfo, investment research does not qualify as an inducement if it is paid for by the investment firm's own resources or from funds deposited by clients in a separate research payment account. Under Article 168aa(2) BGfo, non-monetary benefits may not be received in relation to the provision of portfolio management and independent investment advice. The only possibility for receiving investment research from third parties is therefore to pay for it in one of the ways described above.

Various options are available for other investment services and ancillary services. Here too, an investment firm may receive investment research from third parties by paying for it in one of the above-mentioned ways. An investment firm may also choose to receive investment research without paying for it, as long as it can demonstrate that the requirements of Article 168aa(5) BGfo are met.

Recital 28 DD clearly states the definition of the term 'investment research':

> *"Research in this context should be understood as covering research material or services concerning one or several financial instruments or other assets, or the issuers or potential issuers of financial instruments, or be closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector. That type of material or services explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets, or otherwise contains analysis and original insights and reaches conclusions based on new or existing information that could be used to inform an investment strategy and be relevant and capable of adding value to the investment firm's decisions on behalf of clients being charged for that research."*

As shown by the definition provided in Recital 28 DD, the term 'investment research' should be broadly interpreted. Material relating to non-financial instruments such as real estate or private equity may qualify as investment research if it meets the description in Recital 28 DD. The AFM stresses that virtually all material referred to in the market as 'research' will qualify as investment research as defined in MiFID.

The AFM expects an investment firm to include an adequate definition of investment research in its procedures and measures and to use this definition in the process it has formulated for monitoring all its incoming material, both written and non-written, and for determining whether it can be accepted.

6. Conclusion

The review shows that the investment firms reviewed still need to take the necessary steps to comply fully with the obligations relating to cost transparency, product governance and inducements. Several of the investment firms reviewed took the opinion that certain new and/or stricter obligations under MiFID II could be complied with by compliance with the existing obligations under MiFID I. The AFM stresses that MiFID II contains many new and stricter obligations, also with respect to the provision of services to professional clients and ECPs. Compliance with these obligations demands a serious effort from investment firms and these obligations cannot be met by complying with the existing obligations under MiFID I.

The AFM expects investment firms that provide investment services to professional clients and ECPs to implement the necessary improvements in their organisations on the basis of the contents of this report. Although the specific recommendations in this report are restricted to the three topics reviewed, the AFM expects the investment firms concerned to also take a critical look at the extent to which they comply with the MiFID II obligations relating to other topics.

Appendix: rules frameworks

The frameworks used by the AFM for its review are explained below. No rights may be derived from this explanation. Changes to legislation and regulations at national or international level may mean that the text is no longer up to date when you read it.

Rules framework for cost transparency

On 17 July 2019, ESMA published a 'Call for evidence' inviting all stakeholders to respond to a number of questions it posed in this document, including with respect to the issue of cost transparency. The responses to this Call for evidence are published on the ESMA website[15]. It is very possible that the obligation to provide ex-ante cost information to professional clients and ECPs will be changed as a result of this consultation. This may affect the rules listed in the framework below.

Based on the following rules framework, the AFM assessed the extent to which the institutions have complied with the rules on cost transparency (Article 4:20(1) of the Financial Supervision Act (**Wft**), Article 58 of the Decree on Conduct of Business Supervision of Financial Undertakings under the Wft (Besluit Gedragstoezicht financiële ondernemingen Wft (**BGfo**)), and Articles 46 and 50 of the MiFID II Delegated Regulation (**DR**))[16]. The rules governing cost transparency are further elaborated in the Q&A of ESMA on MiFID II and MiFIR investor protection and intermediaries topics[17] (**ESMA Q&A**). The AFM includes the ESMA Q&A in its explanation of these rules.

i. Provision of information on all costs and related charges prior to the provision of an investment service or an ancillary service

Rule. Prior to the provision of an investment service or an ancillary service (**the service provision**), an investment firm shall provide information to a client regarding all costs and related charges (**all costs**) of the service (Article 58(1) BGfo).

The information on all costs shall include all the costs and related charges for the provision of investment services or ancillary services and, where relevant, the costs of the financial instrument in question and how the client may pay for it (Article 58(3) BGfo).

- If an investment firm does not recommend or market any financial instruments to the client and is not obliged to provide a UCITS KIID or a PRIIPs KID, it shall inform the client about all costs and charges related to the investment service and/or ancillary service provided (Article 50(6) DR).

- An investment firm that recommends or markets services provided by a different firm to its client or refers its client to another firm shall aggregate the costs of the services provided by the other firm with the costs of its own service provision (Article 50(7) DR).

[15] See https://www.esma.europa.eu/press-news/consultations/call-evidence-impact-inducements-and-costs-and-charges-disclosure.

[16] Delegated Regulation (EU) 2017/565 of 25 April 2016.

[17] ESMA, Questions and Answers On MiFID II and MiFIR investor protection and intermediaries topics, 3 October 2018, part 9, pages 72-83 (ESMA35-43-349).

- If in its service provision an investment firm also recommends or markets financial instruments to its client, or is obliged to provide a UCITS KIID or a PRIIPs KID, it shall also provide information on all costs associated with the manufacturing and managing of these financial instruments (Article 50 (5) DR).

The costs referred to above are listed in tables I and II of Annex II, DR (Article 50 (2) DR).

ii. Costs in foreign currency

Rule. Where any part of the total costs and charges is to be paid or represents an amount of foreign currency, the investment firm shall provide an indication of the currency involved and the applicable currency conversion rate and costs. Investment firms shall also inform clients about the arrangements for payment or other performance (Article 50(3) DR).

iii. Illustration

Rule. The investment firm shall provide their clients with an illustration showing the cumulative effect of costs on the return. Such an illustration shall show the effect of the total costs on the return of the investment, show any expected spikes or fluctuations in the costs, and be accompanied by a description of the illustration (Article 50(10) DR and ESMA Q&A 9.2 and 9.3).

iv. Timing of information provision

Rule. An investment firm shall provide the information stated under i. to iii. *in good time* before the provision of the investment service or ancillary service (Article 46(2) DR).

In case of the provision of the investment services reception and transmission of orders, order execution and investment advice, an investment firm shall provide the information stated under i. to iii. in good time before the execution of the transaction or provision of the investment advice. In the case of an ongoing relationship as described in ESMA Q&A 9.14, an investment firm shall provide this information in good time before the conclusion of the contract with the client.

v. Medium for information provision

Rule. An investment firm shall provide the information stated under i. to iii. in a durable medium (Article 46(3) DR). The information stated under i. to iii. may also be provided on a website, provided that the conditions specified in Article 3(2) DR are satisfied:

a. the provision of that information on the website is appropriate to the context in which the business between the firm and the client is, or is to be, carried on;
b. the client must specifically consent to the provision of that information in that form;
c. the client must be notified electronically of the address of the website, and the place on the website where the information may be accessed;
d. the information must be up to date;
e. the information must be accessible continuously by means of that website for such period of time as the client may reasonably need to inspect it.

vi. Presentation of the information

Rule. The information on all costs and related charges, in connection with the service and the financial instrument, other than those caused by the occurrence of the underlying market risk, shall be aggregated so that the client is informed regarding the overall cost and the cumulative effect on return and is provided with an itemised breakdown of the costs on request (Article 58(4) BGfo and Article 50(2) DR). This breakdown shall be at least at the level of the cost items that are depicted in tables I and II (left-hand column) in Annex II DR (ESMA Q&A 9.13).

The investment firm shall present all costs as a cash amount and as a percentage (Article 50(2), last sentence DR). If the cost figures are zero, these shall be reported as zero and not left out (ESMA Q&A 9.20).

The costs must be presented in a manner that is clear and comprehensible. If for instance an investment firm offers a range of ongoing services with different charges associated with each service, the firm should disclose the costs associated with the service that the client subscribes to (Recital 78 DR).

vii. Calculation methodology

Rule. 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 adjustments to these assumptions, where necessary (Article 50(8) DR).

Ex-ante information on costs in relation to the financial instrument or ancillary service can be provided based on an assumed investment amount. However, the costs and charges disclosed should represent the costs the client would actually incur based on that assumed investment amount. (Recital 78 DR).

Estimations are considered to be reasonable if they include all the variables that directly impact the costs that are expected to be incurred by the client, using actual client, portfolio or transaction data to the extent available and making assumptions otherwise. Examples of these variables include the type of instrument the client wants to buy or sell, the costs of the financial instrument and the size of the transaction. When the investment service provided to the client involves an ongoing relationship, the ex-ante cost estimation would need to cover a certain period This requires a number of forward looking assumptions such as the duration of the relationship, the average invested amount, the financial instruments included in the portfolio and the characteristics of the envisaged transactions (ESMA Q&A 9.14 and 9.15).

For clear information on the costs of financial instruments, the AFM considers the calculation methodology as stated in Annex VI of the PRIIPs RTS worthy of recommendation[18]. If available, the cost information in the PRIIPs KID can also be applied (ESMA Q&A 9.6 and 9.7).

Any difference between the value of a financial instrument that an investment firm has assigned to it and the price that a client pays for it must be reported as costs (ESMA Q&A 9.16).

Rules framework product governance

Based on the rules framework below, the AFM has assessed the extent to which investment firms have complied with the rules on product governance for distributors (Article 32b BGfo). These rules are further elaborated in the ESMA Guidelines on MiFID II product governance requirements (**ESMA Guidelines**).[19] The AFM applies these guidelines in its supervision of compliance with the relevant conduct rules in the Wft and the BGfo.

The product governance requirements have wide application for investment services, financial instruments and client types. At the same time, Recital 18 of the MiFID II Delegated Directive (**DD**)[20] makes it clear that the principle of proportionality applies, taking into account the nature of the financial instrument, the investment service and the target market. Proportionality means that rules have to be applied in a manner ranging from relatively simple to more in-depth depending on these factors. With regard to the third factor, the target market, the AFM takes the view that the rules can be applied less deeply for the provision of services to professional clients and ECPs. In its elaboration of the rules for product governance presented below, the AFM has taken account of the proportionality principle for the provision of services to professional clients and ECPs.

[18] Delegated Regulation (EU) 2017/653 of the Commission of 8 March 2017 to supplement Regulation (EU) no. 1286/2014 of the European Parliament and the Council on essential information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents, https://eur-ex.europa.eu/legal-content/and/TXT/?uri=CELEX%3A32017R0653.

[19] ESMA Guidelines on MiFID II product governance requirements, 5 February 2018 (ESMA35-43-620).

[20] Delegated Directive (EU) 2017/593 of the Commission of 7 April 2016.

i. Procedures and measures

Rule. An investment firm shall have adequate procedures and measures in place to ensure that the financial instruments are compatible with the needs, characteristics and objectives of the target market and its distribution strategy is consistent with the relevant target market (Article 32b(1) BGfo).

An investment firm must make clear at least the following aspects in its procedures and measures in order to achieve this aim:

a. How the target market is defined. For this, an investment firm shall take account of the following:
    - The investment firm shall determine the target market for all financial instruments that it distributes or may distribute (see ESMA Guideline 27-29). In the opinion of the AFM, financial instruments forming part of an existing investment portfolio for which the investment firm is providing the investment services of portfolio management or investment advice are covered by 'distribution of a financial instrument'. The underlying principle here is that the portfolio manager continually monitors the suitability of the portfolio and takes investment decisions with respect to the investment portfolio. This also includes decisions about whether to retain a particular instrument in the investment portfolio, and is not restricted to buy and sell decisions.
    - In the target market identification, the investment firm shall in any case apply the five categories applying to target market identification in the ESMA Guidelines: type of client, knowledge and experience, financial situation, risk tolerance, and objectives and needs. Regardless of the client type, these five categories must always be defined (see also ESMA Guidelines 14 and 16 and the explanation by ESMA in paragraph 20 of the background section in the ESMA Guidelines).
    - When identifying the target market, an investment firm shall consider the nature of the financial instrument. The more complicated the financial instrument in question is, the more detailed the identification of the target market has to be (see Recitals 18 and 19 DD).
    - If the financial instruments are manufactured by a manufacturer that has to comply with the product governance requirements (**MiFID manufacturer**), the investment firm shall take the target market identified by the manufacturer into consideration. For more complicated financial instruments, it will identify its own target market in more detail on the basis of the target market identified by the manufacturer and the information on its own clients (see also ESMA Guidelines 34-38). An investment firm shall also identify the target market for financial instruments that are not developed by a MiFID manufacturer.
    - The investment firm shall use clear criteria and definitions for defining the target market categories (see also ESMA Guideline 20).

- o If a target market is defined on the basis of a cluster of financial instruments (**clustering**) instead of an individual financial instrument, the investment firm shall state the basis on which it has arrived at this clustering.

b. How the negative target market is defined for each financial instrument.

c. How the distribution strategy is determined for each financial instrument. The procedures and measures should show how the chosen distribution strategy ensures that the financial instrument is distributed to the intended target market (see also ESMA Guideline 33). As part of its procedure for formulating its distribution strategy, the investment firm, taking account of the principle of proportionality, must also clearly state how, in the actual distribution of the financial instruments, it monitors whether the clients to whom the financial instrument is distributed belong to the intended target market for the financial instrument concerned or not. In principle, an investment firm should distribute financial instruments solely to the identified target market. In the case of portfolio management or investment advice, deviation from the target market is permitted for the purpose of diversification or hedging, with substantiation. If an investment firm makes use of this exception, it must show how it records these deviations (ESMA Guideline 52-55).

d. The manner and regularity of evaluation of the policy and the financial instruments (target market and distribution strategy). The procedures and measures must show how the investment firm ensures that the target market and the distribution strategy remain consistent with the features of the financial instrument, and must detail the information necessary for this and the circumstances giving rise to an evaluation.

e. The structure of the governance. The procedures and measures must show how the persons in charge of day-to-day policy monitor policy and receive periodic reports on the financial instruments distributed and investment services provided.

f. How the manufacturer is kept informed with respect to the financial instruments distributed and the findings of the periodic evaluations. This concerns information that the manufacturer needs to evaluate the financial instrument and to establish that the identified target market is still consistent with the features of the financial instrument (see also Recital 20 DD).

ii. <u>Obtaining information</u>

Rule. An investment firm shall have procedures and measures in place for obtaining information on the features and risks of each financial instrument, including the target market and distribution strategy, and to understand the intended target market (Article 32b(3) BGfo).

These procedures and measures should show the information on which the investment firm bases its identification of the target market for the financial instruments. If the financial instruments are developed by a MiFID manufacturer, the information should also include the target market identified by the manufacturer. For financial instruments not developed by a MiFID manufacturer, the investment firm shall take all reasonable steps to ensure that it obtains appropriate and reliable information from the manufacturer for the financial instrument concerned (ESMA Guidelines 61 and 62).

iii. Oversight by persons in charge of day-to-day policy

Rule. The persons in charge of day-to-day policy at an investment firm shall have control over the procedures and measures and receive periodic reports on the financial instruments distributed and investment services provided (Article 32b(4) BGfo).

iv. Target market and distribution strategy

Rule. An investment firm shall identify the target market and distribution strategy based on the information from the manufacturer of the financial instrument and the information on its own clients (Article 32b(6) BGfo). This target market shall in any case be defined on the basis of the five target market categories in the ESMA Guidelines. The detail of definition of the target market should be in line with the nature of the financial instrument (see also Recital 20 DD and ESMA Guidelines 41 and 42).

The target market identified for a financial instrument should always include at least the five target market categories in the ESMA Guidelines, regardless of the type of client for whom the financial instrument is intended (see ESMA Guideline 14 and 16 and the explanation by ESMA in paragraph 20 of the background section in the ESMA Guidelines). Moreover, the definition of a target market cannot be replaced by the assessment of suitability or appropriateness (see the Explanatory Memorandum to the Decree on Implementation of the Markets in Financial Instruments Directive 2014[21] and ESMA Guideline 33).

v. Negative target market

Rule. An investment firm shall identify the target market for which the financial instrument is not appropriate (Article 32b(2) BGfo).

vi. Periodic policy evaluation

Rule. An investment firm shall periodically evaluate its procedures and measures and adjust these if necessary (Article 32b(7) BGfo).

vii. Periodic evaluation of financial instruments

Rule. An investment firm shall evaluate periodically or when there is reason to do so whether the financial instruments and the services it provides meet the objectives of the target market and whether the distribution strategy is still appropriate for the target market, and make any necessary adjustments (Article 32b(8) BGfo). For instance, it is important that the investment firm establishes whether the target market is still compatible with the financial instrument, or that it checks whether the financial instruments are actually reaching the target market.

[21] *Bulletin of Acts and Decrees 2017*, 513, pages 69 and 70.

viii. Information to the manufacturer

Rule. An investment firm shall provide relevant information on the distributed financial instruments and the results of the periodic evaluations to the manufacturer of the financial instrument in question (Article 32b(9) BGfo). This concerns information that the manufacturer needs to evaluate the financial instrument and to establish that the identified target market is still compatible with the features of the financial instrument (Recital 20 DD).

Rules framework for inducements

The AFM has assessed the extent to which the rules on inducements (Article 168aa BGfo) have been complied with on the basis of the rules framework below. ESMA has provided further guidance on the rules on inducements in the ESMA Q&A[22].

i. Receipt of monetary inducements for portfolio management and investment advice on an independent basis

Rule. If an investment firm receives monetary inducements from third parties in relation to portfolio management or investment advice on an independent basis, it shall transfer these in full to the professional client concerned (Article 168aa(1) BGfo).

An investment firm shall set up and implement a policy to ensure that any monetary inducements received from a third party are allocated and transferred to each individual professional client and shall inform the client in a detailed, accurate and comprehensible manner regarding the existence, nature and amount, or if the amount is not available, the method of calculation of the amount, of monetary inducement prior to the service in question being provided and the mechanisms for passing on monetary inducement to the professional client (Article 168aa(3) BGfo).

ii. Receipt of non-monetary inducements for portfolio management and investment advice on an independent basis

Rule. An investment firm shall not accept any non-monetary inducements from third parties other than minor non-monetary benefits (**MNMB**) in relation to the provision of portfolio management or investment advice on an independent basis to a professional client (Article 168aa(2) BGfo).

An investment firm must clearly state what forms of MNMB it may receive from a third party in relation to the provision of portfolio management or investment advice on an independent basis to a professional client. These forms should correspond to the exhaustive list stated in Article 12(3) DD, and further elaborated in ESMA Q&A 7.6 to 7.9. An investment firm should also clearly state how it assesses whether an MNMB is reasonable and proportionate and of a such a scale that it is unlikely that the firm's behaviour could be influenced in any way that is detrimental to the interests of the relevant client (see also ESMA Q&A 7.6).

Lastly, under Article 35(1) BGfo, the AFM expects an investment firm to keep a record of all MNMB it has received from third parties in relation to the provision of portfolio management or investment

[22] ESMA, Questions and Answers On MiFID II and MiFIR investor protection and intermediaries topics, 3 October 2018, sections 7 and 12, pages 52-65 and 89-95, (ESMA35-43-349).

advice on an independent basis. For each MNMB accepted from a third party, the investment firm should clearly state how it has assessed that the benefit is reasonable and proportionate and of such a scale that it is unlikely that the firm's behaviour could be influenced in any way that is detrimental to the interests of the relevant client.

iii. Receipt of inducements for services other than portfolio management and investment advice on an independent basis

Rule. If an investment firm receives inducements from third parties in relation to the provision of services other than portfolio management or investment advice on an independent basis to a professional client, or in relation to the provision of ancillary services to a professional client, these must meet the following requirements: 1) the inducements must enhance the quality of the service as referred to in Article 11(2) and (4) DD, 2) the inducements may not lead to conflicts of interest and may not conflict with the investment firm’s obligation to act in the best interests of the professional client, and 3) the professional client must be kept adequately informed with regard to the inducements (Article 168aa(5) BGfo).

Article 11(2) DD states that a fee, commission or non-monetary benefit shall be considered to enhance the quality of the relevant service to the client if the following three conditions are met: 1) it results in an additional or higher level of service to the relevant client, proportional to the level of inducement received, 2) it does not directly benefit the recipient firm, its shareholders or employees with tangible benefit to the relevant client, and 3) an ongoing benefit is provided to the relevant client in relation to an ongoing inducement. Article 11(4) DD then states that an investment firm shall hold an internal list of any fees, commissions and non-monetary benefits received. This list shall state how the fees, commissions and non-monetary benefits enhance the quality of the services provided to the relevant clients and the steps taken to ensure that the obligation of the investment firm to act honestly, fairly and professionally in accordance with the best interests of the client.

iv. Payment of inducements

Rule. If an investment firm pays inducements to third parties in relation to the provision of an investment service or an ancillary service to a professional client, these must meet the following requirements: 1) the inducements must enhance the quality of the service as referred to in Article 11(2) and (4)DD, 2) the inducement may not lead to conflicts of interest and may not conflict with the investment firm’s obligation to act in the best interests of the professional client, and 3) the professional client must be kept adequately informed with regard to the inducement (Article 168aa(6) BGfo, in conjunction with Article 168aa(5) (a) (2) BGfo).

Article 11(2) DD states that a fee, commission or non-monetary benefit shall be considered to enhance the quality of the relevant service to the client if the following three conditions are met: 1) it results in an additional or higher level of service to the relevant client, proportional to the level of inducement paid, 2) it does not directly benefit the recipient firm, its shareholders or employees with tangible benefit to the relevant client, and 3) an ongoing benefit is provided to the relevant client in relation to an ongoing inducement. Article 11(4) DD then states that an investment firm shall hold an internal list of all fees, commissions and non-monetary benefits paid. This list shall

state how the fees, commissions and non-monetary benefits enhance the quality of the services provided to the relevant clients and the steps taken to ensure that the obligation of the investment firm to act honestly, fairly and professionally in accordance with the best interests of the client.

Investment research

With respect to portfolio management and investment advice on an independent basis, no research may be received from third parties without this being paid for. For other services, this is only permitted subject to certain conditions. An investment firm may pay for research received from third parties from its own funds or from funds deposited by clients in a research payment account (RPA). The specific rules applying to the receipt of research are described below.

i. <u>Process for evaluation of incoming material and definition of research</u>

Rule. An investment firm shall have a procedure in place to assess whether incoming information, either written or not, may be received (ESMA Q&A 7.3). This should clearly state the department of the investment firm with responsibility for this assessment. The information shall be evaluated on the basis of the description of research as given in Recital 28 DD. Research should be understood as:

"research material or services concerning one or several financial instruments or other assets, or the issuers or potential issuers of financial instruments, or be closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector. That type of material or services explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets, or otherwise contains analysis and original insights and reaches conclusions based on new or existing information that could be used to inform an investment strategy and be relevant and capable of adding value to the investment firm's decisions on behalf of clients being charged for that research."

An investment firm shall take reasonable steps to cease receiving unwanted material or avoid benefiting from its content, for example by automatically blocking the sender. Employees receiving or in a position to receive such information from third parties shall be made aware of this procedure.

ii. <u>Research payment account (RPA)</u>

Rule. If research meets the criteria of Article 13(1) (b) DD, it does not constitute an inducement (Article 168aa(7) BGfo). An RPA must meet the conditions listed below.

iii. <u>Research budget</u>

Rule. When setting up an RPA and agreeing a research charge with its clients, an investment firm shall set and regularly assess a research budget (**the research budget**) by internal administrative measure (Article 13(1) (b) (ii) DD).

The following requirements for the research budget are laid down in Article 13(4), (5) and (6) DD:

a. The total amount of research charges received may not exceed the research budget;

b. The research budget may only be increased after the clients have been informed of this;
c. The research budget shall be managed solely by the investment firm;
d. The research budget will be set on the basis of a reasonable assessment of the need for third party research.

ESMA Q&A 7.10 states that while an RPA may only be funded by means of a specific research charge to the client, a research budget may also be established for a group of client portfolios or accounts with similar research needs. The investment firm is in this case still obliged to identify a specific research charge to each individual client. There must be a transparent method in place for fairly allocating the costs between clients, for example on the basis of a client's invested assets.

The research budget is established in advance. It is an estimate of the amount that must be properly substantiated and it must take account of the client's interests (ESMA Q&A 7.10).

iv. Specific research charge

Rule. The RPA is funded by a specific research charge to the client (Article 13 (1) (b) (i) DD). This specific research charge must meet the following requirements (Article 13(2), (3) and (5) DD):

a. The charge is based on a previously established research budget for research from third parties that is needed for the provision of the services to clients.
b. The charge is not linked to the volume and/or the value of transactions of clients.
c. The charge must be charged to the client as a separately identifiable item.
d. In the firm's investment management agreement or general terms of business, the investment firm shall agree with its clients the research charge as budgeted by the firm and the frequency with which the specific research charge will be deducted from the resources of the client over the year.
e. If there is a surplus in the RPA at the end of a period, the firm should have a process to rebate those funds to the client or to offset it against the research budget and charge calculated for the following period.

In Q&A 7.1 and 7.10, ESMA also states the following with respect to the specific charge:

a. An investment firm must ensure that the RPA must not hold unused funds for too long a period (the length of time between receipt and payment should be as short as possible).
b. The RPA must be a separate account.
c. There may be no correlation between the transaction volumes that a broker executes on behalf of a portfolio manager and any 'discount' applied to the research material that is offered to this same portfolio manager.

v. Appropriate checks of expenditure

Rule. The allocation of the research budget to purchase third party research shall be subjected to appropriate controls and senior management oversight to ensure it is managed and used in the best interests of the clients of the investment firm. These controls shall include a clear audit trail of the payments and describe how the amounts paid are determined with reference to the quality

criteria referred to in Article 13 (1) (b) (iv) DD (Article 13 (1) (b) (ii) and (6) DD). The research budget may not be used to fund internal research.

The decision to purchase research may not be affected by the other investment services provided by the investment firm. The investment firm must check this and establish a procedure for this in its policy (ESMA Q&A 7.10).

vi. Provision of information on the costs for third-party research to clients

Rule. An investment firm shall provide the following information to its clients (Article 13 (1) last paragraph DD):

a. Before the provision of the investment service, information about the budgeted amount for research and the amount of the estimated research charge to the client;
b. Annual information on the total costs incurred for third-party research for each client.

The estimated amount of the specific charge to the client must be expressed as both a percentage (or basis points) and a monetary amount. The estimate of the amount may be described as a maximum, with a guarantee by the investment firm that the charge to the client will not exceed this maximum. Presentation of the charge as a range is not permitted (ESMA Q&A 7.11).

vii. Summary overview

At the request of the client or the supervisor, an investment firm must be able to provide a summary overview stating the following information (Article 13(2), first sentence DD):

1. the providers of the research paid for from the RPA;
2. the total amount of payments over a defined period;
3. the benefits and services received by the investment firm;
4. how the total amount spent from the account compares to the budget set by the firm for that period, noting any rebate or carry-over if residual funds remain in the account.

viii. Research policy

Rule. An investment firm shall have a research policy that is provided to clients. In this policy, the investment firm shall state all the necessary information in connection with the evaluation of the quality of the research purchased that must be carried out regularly on the basis of robust quality criteria and the ability of the research to contribute to better investment decisions. The research policy shall include a clear description of the quality criteria and the ability of the research to contribute to better investment decisions. The research policy shall state the regularity with which the investment firm carries out this evaluation.

In addition, the research policy describes the research that can be purchased on behalf of client portfolios from the funds in the RPA, taking account of the investment strategies applicable to various types of client portfolios and the approach taken by the investment firm to allocate the costs fairly to the various clients' portfolios (Article 13(1), last paragraph, (2) and (8) DD).

ix. Evaluation of research quality

Rule. An investment firm shall regularly assess the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions (Article 13(1) (b) (iv) DD).

In Q&A 7.1, ESMA stresses that in this evaluation, an investment firm must ensure that the purchase of research is in the client's best interest (ESMA Q&A 7.1).

x. Delegation of management of the RPA

Rule. An investment firm is held responsible for the research payment account. An investment firm may delegate the administration of the RPA to a third party, provided that the arrangement facilitates the purchase of third-party research and payments to research providers in the name of the investment firm without any undue delay in accordance with the investment firm's instruction (Article 13(1) (b) (iii) and (7) DD).

The investment firm must in this case ensure that it retains full power and legal control over the use of this account by means of a delegation agreement with the third party. The funds in the RPA must also be ring-fenced and clearly separated from the other assets of the third party, and measures must be in place to prevent the third party using the funds in the RPA (ESMA Q&A 7.2).

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