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International Investment Disclosure Trends
The dawn of the fully transparent era

In 2018, regulatory change and competing for investors will support a global trend towards further transparency. As a result international capital markets will require transaction costs in investment products' disclosures. **Tiberiu Tucsnak** points out how this requirement is generating significant challenges for market participants.

In Europe, fund managers had to produce new information documents for their products by January 2018, due to implementing the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation. In addition anyone supplying investment products alongside financial advice to European retail investors, must ensure they provided information that complied with the Market in Financial Instruments Directive II (MiFID II), which was also effective January 2018.

Similarly, in Australia, from October 1, 2017, most super funds had to comply with the Australian Securities and Investments Commission's (ASIC) new Regulatory Guide 97 (RG97) – Disclosing fees and costs in PDSs and periodic statements. The intention of RG97 is to enhance comparability between superannuation products. As a result many financial services providers have joined up to form the RG97 industry working group to determine consistent fees and costs disclosure across the industry.

International comparability of fees and costs

Comparability and alignment between countries and markets is another challenge due to the complexity of market structures, legal frameworks and historical business practices.

The recent changes around disclosure have been predominantly driven by regulators wanting global alignment as financial services markets become increasingly interconnected. Regulators in Europe and Australia want the common disclosure objectives for consumers to be comparability, transparency, and ease of understanding. These are enshrined in ASIC's RG97 objectives of:

1. Consumer protection
2. Ability to analyse the superannuation and managed fund industries, including benchmarking of fees and costs
3. Enhancing a consumer's ability to compare fees and costs of products effectively.

There are five key principles around international regulatory bodies' objectives:

	Principle	Description
1	**Improved transparency reflects good culture and governance**	• Transparent disclosure of all fees, underlying costs and conflicts of interest reflect good governance culture and conduct within a fund.
2	**Consistency**	• Disclosure requirements should apply consistently to all funds, regardless of the fund's structure, investment approach or asset allocation. • Consistency across asset classes is needed, e.g. infrastructure investments should be treated in the same way as property investments. • A level playing field across all disclosure and reporting requirements is a key goal for consistency.
3	**Comparability**	• Information on fees and costs should enable members to compare the costs of different funds
4	**Transparency should be provided**	• Funds should disclose all fees and costs which impact an investor's net returns, including the costs borne directly by the fund, and costs which are indirectly charged that reduce investment returns.
5	**Disclosure which is informative and understandable for investors**	• Fees and costs should be disclosed in a clear and comparable format that is informative and useful to both prospective and current investors. • Disclosure should help investors distinguish what is essential

Individual Country Regulatory Authorities are trending towards alignment when considering their own comparability to other relevant markets. However, despite the ongoing alignment between European fund disclosures and their U.S. peers, there is plenty of room for improvement for Australian funds, especially in performance and risk reporting.

1. In August 2016, International Organisation of Securities Commissions (IOSCO) published its final report on 'Good Practice for Fees and Expenses of Collective Investment Schemes'. In the report, IOSCO identified 23 'Good Practice Principles' and provided a detailed explanation of its methodology and observations. The two best practice examples given as evidence were:

- The Key Information Document (KID) fee table for Undertakings for Collective Investments in Transferable Securities (UCITS) in the EU.
- The fee table for Securities and Exchange Commission (SEC) Registered Mutual Funds in the US.

2. The US, UK and EU Regulators and leading Investment Management Associations, consistently refer to the trends in their respective counter-party markets in commentary, publications and submissions to Regulatory Forums. This is also evident in the international development of 'investment product passports', e.g. UCITS from the EU, ETFs from the US, and the ASEAN and ASIAN Passports.

IOSCO suggests fees and costs should be classified into the following broad categories:

1. Fees paid directly to the fund or its operator or related party

2. Fees and expenses borne by the fund:

- Investment management fees
- Distribution costs
- Other fund operating costs
- Transaction costs related to purchase and sale of assets.

There is a global trend towards the 'All in Fee' concept. The All in Fee concept aims to disclose all fees and costs incurred by investors. This concept can be used to explain the total fees and interest included in a financial transaction.

However, IOSCO has not recommended including transaction costs in the All in Fee. Rather, it stresses the need to balance this argument with the practicalities of measurement and the relationship to net return if the fund is remunerated on a net performance basis.

Lessons learned from Australia's RG97 ongoing implementation

- Although ASIC encouraged market participants to create an Industry Working Group to think of the best way to implement RG97, many aspects are still open to interpretation. This means meeting the deadline will be challenging, and it is questionable whether the new requirements will be able to be applied consistently.
- The impact of RG97 on headline costs varies enormously between funds. ASIC indicated that additions to disclosed fees and indirect costs range from a few basis points for some funds to nearly 1% p.a. for others.
- Ultimately, the underlying costs and net returns to members have not changed, however, the appearance of a large increase in fees presents major communication challenges.

High-level RG97 impact on business processes

System	Process	Teams
Statement changes – changes to statement disclosures and layouts have occurred and need to be explained to members.	Data collection supply - processes for the collection, supply and estimation of fees and costs is required.	PDS team volume increase – it is likely that PDSs will now need to be rolled out annually, as the actual fee and cost information for the previous financial year becomes available.
Indirect costs changes – there will be an increased emphasis on disclosing indirect costs to encompass all relevant fees and costs that are directly and indirectly incurred by investing through external fund managers.	Data collection – processes need to be developed to collect and provide fee and cost dates for Product Disclosure Statements	Complaints team volume increase – increases are likely due to the changes in statements not being understood, or perceived price increases.

RG97 also creates several interpretative and operational challenges such as:

- Definition of fees, costs and indirect costs
- Definition of 'Interposed vehicles'
- Collecting data from underlying fund managers

In response to these challenges, ASIC announced in early November 2017, that it will conduct an external review on the effects of the RG97 fee disclosure reforms, and will again extend its previous 30 September 2017 compliance deadline. ASIC said the move was in response to the industry's difficulty in implementing the changes.

ASIC was pleased that funds have been investing in improving fee disclosure thus far, but recognised that 'accurate fee and cost disclosure is complex to implement and that this implementation takes time.'

Market challenges – common pressure points across Europe and Australia
Technical content challenges have emerged around the lack of consensus in regards to:

- Including transaction costs and performance fees
- Using estimates for certain disclosure elements
- Responsibility for revision of Product Disclosure Statements when circumstances change
- Fiduciary Duty: best execution, value for money, responsible manager, best interest of the investor

There are also practical institutional challenges in the EU which are relevant for other markets including:

- Pension and/or investment products that are wrapped inside a Life Insurance Fund will be designated as a PRIIP and therefore included in transition requirements
- Separation of research into a separate fee for service rather than included in commission or distribution charges
- Financial Institutions not wanting to subsidise their asset management arms for the additional IT and restructuring compliance costs, despite being 'vertically integrated' within the institution.

Another key effect of RG 97 is that it will force the superannuation sector to further examine the costs of a manager, especially considering the after-fee performance.

Focus on transaction costs disclosure
There is no generally accepted definition of transaction costs. However, International Financial Reporting Standard 9: Financial Instruments defines transaction costs as: . . . incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have occurred if the entity had not acquired, issued or disposed of the financial instrument.

A granular understanding of the several types of costs and charges is important for all market participants. These can have a substantial effect on investors' returns and, if disclosed effectively, should facilitate market efficiency. With this in mind, regulators have gone to considerable lengths to implement all the necessary requirements related to the disclosure of all costs and charges associated with providing investment services – thereby increasing transparency in the market.

Areas of immediate concern tend looks towards the methods required to estimate transaction costs and more specifically implicit costs.

Implicit costs
One of the most controversial areas which remains unresolved is the common approach to the definition of 'implicit costs'. 'Implicit' transaction costs are difficult to compute. They are described by European Securities and Market Authority (ESMA) in Europe and ASIC in Australia, as all costs incurred in order to acquire and dispose of investments.

In most cases, the professional associations' guidance is that implicit costs will equate to the bid-ask spread for the asset. However, in markets such as fixed income, foreign exchange and derivatives markets, transaction costs are embedded in the bid-ask spread of the financial instrument, so it makes them hard to quantify. The issue deepens when other categories of 'implicit' costs considered by the practitioners of Transaction Cost Analysis (TCA) are added into the equation. Typically, these variables arise in response to the market for a trade or its timing. Specifically they consider:

- **Market impact** – executing a large order in one go can move the market and obtain a different price from that expected
- **Delay** – is the price differential from initiating the order to placing it on the market. Fund performance can be affected if the market moves and elicits a cost
- **Opportunity cost** – if a trade is partially executed it may run the risk of missing out on the opportunity to participate in favourable movements in the market.

  This risk is typically considered to be a loss in value and, consequently, a potential cost.

Typically these transaction costs are estimated by fund managers using proprietary models. However there is a lack of common harmonised models to calculate these costs across firms.

RG97 vs. MiFID II: the growing focus on reducing implicit costs and improving best execution
ASIC's RG97 can be considered a mini MiFID II. It increases focus on those implicit costs that can be minimised with best execution. MiFID II's best execution regulation primarily focuses on indirect transactional costs. When executing orders it seeks to compel the industry to take sufficient steps to obtain the best possible result for their clients.

In 2014, the British Financial Conduct Authority (FCA) investigated the asset management industry and calculated that around £4.2bn of implicit transaction costs could have been avoided.

Both regulations strive for 'client's best interest' and 'transparency'. Where costs are made transparent, all sufficient steps need to be taken to minimise these costs as much as possible.

As a result, Multi-Asset Transaction Cost Analysis (TCA) is expected to gain traction in the Australian market. TCA improves execution quality and fund performance, and should ultimately help attract more business, or increase assets under management. Many asset managers in Australia are already conducting sophisticated TCA, which is often essential to win institutional mandates.

RG97 requires trade data, market data and transparent implicit cost calculations.

1. Obtaining trade data can still be a major hurdle. Under MiFID II, time-stamping trades to the millisecond is now required. This will ultimately benefit buy-side customers. However, it is essential for buy-side firms to evaluate their execution management systems and improve the capture of their trade data. Date stamped custodian data will take this challenge to the next level. TCA is only as good as the quality of trade data.

2. Market data is the second challenge, especially for OTC instruments. Reference points other than bid-ask prices for both bonds and FX are needed for in-depth TCA.

Relying on bid-ask prices from competing quotes as reference points in order to calculate the true implicit costs is irrelevant when selecting the five worst dealers during the RFQ process. Analysis should account for quotes from as many dealers outside the RFQ process as possible when analysing execution quality.

Data providers will be essential to administer this level of data. Again TCA is only as good as the quality of market and pricing data.

The compliance challenges of RG97 are not much different from the best execution requirements under MiFID II. Although directly impacting asset managers and superfunds, it will also impact banks and broker dealers when their client bases becomes more sophisticated.

Like MiFID's best execution requirements, we expect RG97 to cut down implicit transaction costs and improve overall fund performances in the long-term.

Conclusion

The key international best practice trends are:

Disclosure	Regulators and market participants continue to align market practices with regards to the disclosure of investment fees and costs
Interconnectedness	The trends are driven by the need to promote trust as markets increasingly interconnect
Technology	The use of technology is enabling the collation of data across the investment execution value chain, to improve transparency to consumers
Transparency	The level of transparency prescribed by market regulators is generating significant cost and technical challenges
Integration	The complexity of markets requires the alignment of disclosure practices to be integrated

The EU frameworks recognise the investment decisions are complex and not solely driven by cost. Consequently the disclosure framework includes risk, return and remuneration. However, in Australia, the regulator has focused on remuneration reporting and is yet to focus on risk and return reporting.

ASIC stated that 'Asset allocation, investment risk and strategy are clearly also very important, as are elements of services. One area we are very interested in is that the focus should move to looking at netreturns, and that if you have consistency and accuracy in terms of fee disclosure, then the focus can shift to net returns.'

It is expected that ASIC will eventually turn its attention to how to improve reporting investment performance.

The industry recognises the need to provide consumers with both the understanding and power to make better decisions when choosing superannuation products. While both the EU and Australia are moving towards those frameworks through various legislations, there is still a long way to go. Various functions within the industry, ranging from fund managers, product developers, regulatory bodies and superannuation providers need to come together to achieve comparability, transparency, and ease of understanding.

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