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Regulatory Newsflash

PRIIPs and MIFID II: true transparency and comparability at last?

Overview

The Markets in Financial Instruments Directive II (MiFID II) and the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation rules went live in January this year, introducing requirements for firms to disclose specific information on the costs and charges of certain investment products or services. The overriding regulatory objective is to help consumers assess the value for money of these investments - since charges can absorb a significant proportion of total returns – and make more informed investment decisions.

This blog takes stock on the implementation experience of these rules to date and considers how far they have created transparency in the charges borne by investors and established comparability across investment products.

We also provide a brief overview of the UK's Financial Conduct Authority's latest statement relating to concerns raised about the performance scenarios in the Key Information Document (KID).

New Forms of Disclosure under PRIIPs and MIFID II

While UCITS funds[1] have had to produce Key Investor Information Documents (KIIDs) for some time, the introduction of PRIIPs means that firms now need to make available Key Information Documents (KIDs – that is, only one "I") for other investment products, including investment trusts, insurance-based investment products (e.g. with-profits investments), structured investments (e.g. guaranteed income bonds) and structured deposits.

KIDs are standardised, three page documents that provide specific information such as the aggregated charges associated with a PRIIP as well a breakdown of costs, its perceived riskiness, and a variety of performance scenarios. The net effect of the costs included are presented as an annual percentage reduction in yield.

While UCITS funds meet the definition of a PRIIP, they are currently within a transitional period until 31 December 2019 which means they may continue to rely on the UCITS KIIDs, and do not have to produce a PRIIPs KID. Importantly, the UCITS KIID contains a different set of costs and charges information from the PRIIPs KID.

The European Commission will review the PRIIPs regulation by December 2018, to decide whether to:

- Prolong these transitional arrangements,
- Consider the UCITS KIID equivalent to the PRIIPs KID, or
- Require UCITS funds to produce a PRIIPs KID instead of a UCITS KIID.

Alongside the introduction of PRIIPs, MiFID II introduces a requirement for firms to disclose an aggregated cost figure across a variety of investment products, including investment funds, derivatives and individual securities. This figure covers the entire value chain (e.g. cost of advice, platform fee, fund

[1] Including OEICs and Unit Trusts

costs etc.) and will give investors a figure for the total cost of investing for the first time. Clients also have the right to request an itemised breakdown of this figure.

The combined introduction of PRIIPs and MIFID II means that investors should now have a much wider set of costs and charges figures across a much wider set of investments.

In reality, however, we are still some way from true comparability. For example, an investment trust is required to produce a PRIIPs KID in which the ongoing costs figure includes fund portfolio trading costs, while a UCITS fund must produce a UCITS KIID in which the ongoing charges figure does not include portfolio trading costs. Both types of fund are covered by MiFID II so will have to disclose separately a total costs and charges figure that includes fund portfolio trading costs, but not in any prescribed format.

Such differences, which will persist until the Commission's aforementioned review and possibly last longer depending on the decision reached, have led a variety of industry participants to voice concerns that certain PRIIPs and MiFID II disclosures may be misleading, and could therefore create the risk of mis-selling. This has been compounded by concerns about the quality of some of the initial data disclosed, with some firms worried that this may also be inaccurate.

Transaction Costs

PRIIPs

In the PRIIPs KIDs, recurring costs, including the transaction costs, must be disclosed in percentage terms. The PRIIPs delegated act sets out how firms should calculate actual transaction costs: these costs must be determined using an "arrival price", which requires firms to calculate the difference between the bid/ask midpoint price at the point at which a trade is first submitted, and the final execution price of the same trade. This means that the costs disclosed are often heavily influenced by market movements and, in some cases, have resulted in some firms disclosing negative figures for their transaction costs. These negative figures may lead investors to draw inaccurate conclusions about the desirability of certain funds and the true brokerage charges which they will ultimately bear.

MiFID II

MiFID II also requires that asset managers give estimates of their transaction costs for buying and selling securities. Unlike PRIIPs, the MIFID II rules do not set out a specific formula that firms must apply when calculating transaction costs. This means that firms are taking different approaches to calculating their transaction costs, undermining comparability. Furthermore, as firms do not have to disclose their underlying methodologies, it can prove impossible to determine how the final transaction cost figure has been calculated.

However, MiFID II does require that firms give investors transaction cost figures which reflect the price movement between the initial placement of a transaction and its final execution. Like PRIIPs, this has led to some firms disclosing negative transaction costs, which can lead to confusion.

Overall, the rules create the possibility that firms may disclose several different cost figures in different places, making it unclear which figures potential investors should be comparing. For example, it is possible under the rules that firms could disclose an "ongoing charges" figure in their KID; a different figure called "ongoing charges / total expense ratio" as the headline figure on their website; and a different "average annual charge" figure in the more detailed disclosures on their website.

Performance Scenarios

PRIIPs requires firms to produce a range of performance scenarios to include in their KIDs. These are designed to show investors what will happen to the growth of their investment under four market conditions: favourable, moderate, unfavourable, and a stress scenario. The projections given by the scenarios are built by combining data on historic returns with a probability distribution[2], in order to calculate how likely it would be for this historic return to continue in future. A limitation in this methodology is that while it is intended to be forward looking, it is in practice highly dependent upon past performance, and is driven by the historic returns the product has seen over its recommended holding period.

Given the strong performance of markets in recent years, the "moderate" performance scenarios in some funds' KIDs predict returns of over 100% in a single year, or even higher returns over multiple years, using the methodology mandated by PRIIPs.

[2] Value at risk equivalent volatility – VEV

The FCA's Position

The industry has expressed concern that such figures may mislead investors. In response, the FCA has issued a statement in relation to PRIIPs. In its statement, it acknowledges that "*for a minority of PRIIPs, the 'performance scenario' information required in the KID may appear too optimistic and so has the potential to mislead consumers*". The FCA states "*Where a PRIIP manufacturer is concerned that performance scenarios in their KID are too optimistic, such that they may mislead investors, we are comfortable with them providing explanatory materials to put the calculation in context and to set out their concerns for investors to consider*".

It adds that where firms selling or advising on PRIIPs have concerns that the "*performance scenarios in a particular KID may mislead their clients, they should consider how to address this, for example by providing additional explanation as part of their communications with clients*". Notably, however, the FCA's statement stops short of requiring firms to submit additional materials or consider whether they are needed.

Implications for firms

PRIIPs and MiFID II rules now apply, but the thorny issue of costs and charges, together with comparability across products, endures and firms are increasingly asking regulators to review the requirements. There may be further guidance from national regulators and or European authorities in the near future to address some of the issues raised by firms.

Furthermore, the presentation of costs was flagged by the FCA as part of its Asset Management Market Study, published in June last year (for further details, see our blog), and it is considering possible remedies. Specifically, the FCA has said it is "testing ways to improve the effectiveness" of disclosures under MiFID II and PRIIPs to retail investors (for further information, see our blog on this topic).

In the meantime, and in the light of the FCA's statement, it is open to firms to take additional steps to help investors navigate the new costs and charges figures available to them and so reduce the possibility of inaccurate interpretation. Such steps might include:

- Presenting all information on costs and charges in one easily accessible place, so that consumers do not need to hunt through different documents.

- Explaining how various cost and charges figures are calculated, why they may differ, and how they might be compared.
- Where firms consider a figure to be potentially misleading, explaining why they are required to produce it, and warning consumers about its limitations.

Contact

For further information with respect to this subject, please contact Caroline Veris, Patricia Goddet or Fran Ravelingien.

Caroline Veris
Partner – FSI Governance, Regulatory & Risk

Patricia Goddet
Director – FSI Governance, Regulatory & Risk

Fran Ravelingien
Senior Manager – FSI Governance, Regulatory & Risk

EMEA Centre for Regulatory Strategy
Andrew Bulley, *Partner*