

# **PRIIPs Call for Input Feedback Statement**

## **Feedback Statement**

FS19/1

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## This relates to

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# 1 Summary

## What is this Feedback Statement about?

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- 1.1** In July 2018, we published a Call for Input (Cfi) seeking views and evidence on market participants' initial experiences of the requirements introduced by the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation (Regulation (EU) No 1286/2014) and the related PRIIPs Regulatory Technical Standards (RTS) (Commission Delegated Regulation (EU) 2017/653), together the PRIIPs legislation. The PRIIPs legislation took effect in January 2018.
- 1.2** The PRIIPs legislation requires those who produce, advise on or sell PRIIPs to retail investors in the European Economic Area (EEA) to prepare and provide consumers with a standardised key information document (KID) on each product. The KID aims to improve retail consumers' understanding of investment products by standardising the information they receive, allowing them to more easily compare products. The PRIIPs legislation is directly applicable EU law and so any amendments can only be done by the EU.
- 1.3** We published the Cfi to seek input from firms and consumers about their initial experiences of the PRIIPs legislation during the first half of 2018. We requested input based on the following themes:
- a.** Problems with clarifying the scope of the PRIIPs Regulation.
  - b.** The calculation of transaction costs, which are required as part of the KID.
  - c.** The presentation and calculation of 'performance scenarios' in the KID, which are intended to indicate the level of returns a consumer could expect from a product in different market conditions.
  - d.** The presentation and calculation of the 'summary risk indicator' (SRI) and description of other key risks in the KID, which should provide a consumer with an overview of the main risks associated with a product.
- We also sought feedback on any other aspects of the PRIIPs legislation, including positive views on its impact for consumers.
- 1.4** The Cfi generated a high level of interest. We received 103 responses from firms, trade bodies and consumer organisations. In this Feedback Statement (FS):
- We summarise responses received to the Cfi.
  - We set out our responses to the feedback received.
  - We outline options to address areas of concern.
- 1.5** We set out our next steps. This includes working with the European Supervisory Authorities (ESAs), the European Commission and HM Treasury to encourage change at European-level during the review of the PRIIPs legislation, expected to be carried out during 2019. We will continue to work closely with industry, and will consider the extent to which consulting on domestic interpretive guidance could mitigate some of these

issues. The UK is due to leave the European Union at 11pm on 29 March 2019<sup>1</sup> (exit day). The European Union (Withdrawal) Act 2018 converts the existing body of directly applicable EU law, such as the PRIIPs legislation, into UK domestic law. In February 2019 Parliament approved a statutory instrument to ensure that the PRIIPs legislation would continue to operate effectively in the UK when the UK leaves the EU.

## Who does this FS apply to?

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**1.6** This FS will be of interest to:

- consumers and their representative bodies
- those who manufacture PRIIPs and those who advise on or distribute PRIIPs, including:
  - issuers of securities that are or may be classed as PRIIPs (including businesses that do not require Part 4A authorisation under FSMA)
  - life companies
  - discretionary investment management firms
  - firms providing services in relation to insurance-based investments
  - fund managers
  - wealth managers
  - stockbrokers and other firms that provide advice to retail clients on funds, structured products and derivatives
  - financial advisers
  - firms operating retail distribution platforms

## The wider context of this FS

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**1.7** The aim of the KID is to provide investors with standardised, consumer-friendly information about the key features of investment products. This includes what they might gain if they invest, the risks they are taking, and all the costs they will incur. All PRIIPs offered in the retail market must be accompanied by a KID. Examples of PRIIPs are: units in investment funds, structured investment products, structured deposits and unit-linked and with-profits life insurance contracts.

### Our Call for Input

**1.8** In our Cfi, published in July 2018, we gave an overview of the requirements of the new PRIIPs legislation and the broader regulatory context. To better understand the experience of firms and consumers with the new requirements, we asked for feedback on any products where the scope of PRIIPs was unclear. We also asked for evidence of the transaction costs, performance scenarios, and risk disclosure methodologies not producing the expected results.

**1.9** We said that we would analyse the responses and publish a feedback statement in Q1 2019. The responses would also be used to inform our anticipated future engagement on the PRIIPs legislation with the European Commission, ESAs and other national

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<sup>1</sup> European Union (Withdrawal) Act 2018, s 20(1)

competent authorities. We have provided an overview of the evidence we shared with the ESAs and Commission to inform their work.

- 1.10** Since we published the Cfi last year, there have been developments at EU level. The ESAs have consulted on a targeted review of PRIIPs, focusing on performance scenarios. A particular focus was on the impact of extending the regime to include Undertakings for Collective Investment in Transferable Securities (UCITS) which had been planned to take effect on 1 January 2020.
- 1.11** An amendment to the PRIIPs Regulation was passed by the European Parliament in December (through an amendment to the Cross-Border Distribution of Funds Directive). This extends until 31 December 2021 the exemption for UCITS producing a PRIIPs KID. It also passed an amendment to set a new deadline for the Commission to complete a full review of the PRIIPs Delegated Regulation by the end of 2019. These amendments are expected shortly to be formally agreed by Member States, the Commission and the Parliament following 'trilogue' negotiations.
- 1.12** The ESAs published their Final Report on their targeted review in February 2019 and concluded that the work of this review should be rolled into the full review being carried out during 2019. The ESAs also published a Supervisory Statement alongside their Final Report that provides for a further warning in the KID that the performance scenarios are only an indication of some of the possible outcomes based on recent returns.

## Summary of feedback and our response

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- 1.13** We received responses to all of the questions we asked in the Cfi. We summarise the responses briefly below and in more detail in Chapter 2 based on the main topics on which we sought input.
- 1.14** We believe that the concerns raised about uncertainty about scope and unintended effects of compliance with PRIIPs requirements are particularly serious and may risk causing consumer harm if not addressed. In these areas, we are seeking and encouraging swift and effective action from EU institutions. We will consider the extent to which domestic interpretive guidance from the FCA could mitigate these issues. This work will take into account the UK's future relationship with the EU.

## Scope of the PRIIPs Regulations

- 1.15** Industry responses express considerable uncertainty regarding the application of PRIIPs Regulation for certain types of investment. Respondents identified corporate bonds as a key concern. A number of common contractual features of these securities could potentially bring them within scope of the PRIIPs legislation. Evidence received suggests that this has already reduced choice and liquidity in the retail bond market. Many issuers and brokers are avoiding retail issuances to avoid PRIIPs-related compliance risks.
- 1.16** We have engaged with the Commission and ESAs during and following the Cfi to highlight this issue and to share the evidence we have received. We would strongly support EU-level clarifications on the scope of the PRIIPs Regulation for corporate bonds. This was also proposed in a public letter from the ESA Joint Committee (JC)

to the Commission on 19 July 2018. We believe that EU-level clarification is the most appropriate and effective solution to the legal uncertainty over requirements for a KID for corporate bonds. We have significant concerns about the lack of clarity about scope of application of the PRIIPs Regulation's requirements. We will consider the extent to which domestic interpretive guidance could mitigate some of these issues.

### Summary Risk Indicators

- 1.17** We received feedback that the Summary Risk Indicator (SRI) appeared to deliver lower risk ratings than expected where the underlying or reference asset is illiquid. There were also concerns that the presentation of the SRI gives a misleading impression that the scale rating reflects the overall level of investment risk associated with the product, when it is mainly a measure of price volatility. For some investment products, price volatility is a less relevant risk. Other risks not captured in the SRI are more significant but are only explored briefly in the accompanying description. This could mislead investors.
- 1.18** We are particularly concerned that the prescribed methodology for calculating the SRI in the PRIIPs RTS can result in KIDs for products such as Venture Capital Trusts (VCTs) having a significantly lower risk rating than we, and the industry, would generally consider appropriate.
- 1.19** We are actively discussing these issues with the Commission and ESAs to ensure that the SRI better represents the risks of illiquid PRIIPs. We will consider the extent to which domestic interpretive guidance could mitigate some of these issues.

### Performance scenarios

- 1.20** Cfi responses expressed significant concerns that the current methodology for presentation of performance scenarios produce misleading illustrations across almost all asset classes. A number of responses stated that the performance scenarios for alternative investment funds and investment trust companies are very misleading.
- 1.21** There was universal agreement in responses that the problems were caused by a reliance on past performance in the PRIIPs RTS methodology itself. Due to market conditions in the 5 years before 2018, a high proportion of KIDs were identified as displaying possible returns that, according to responses, are significantly over-optimistic.
- 1.22** We share respondents' concerns about misleading performance scenarios. We have been working closely with the ESAs to address this issue and contributed to the ESA Consultation Paper published in November 2018. We will continue to push for changes at EU level for a solution to the PRIIPs requirements that produce misleading performance scenarios. We will consider the extent to which domestic interpretive guidance could mitigate this issue.

### Transaction costs

- 1.23** In the Cfi, we highlighted concerns that some KIDs were displaying negative, zero or very high transaction costs that are unlikely to fairly represent the true transaction costs of the product. However, responses to the Cfi did not provide credible evidence to support claims that the methodology is not working as intended. Our analysis, both of the evidence received in the Cfi and from ongoing supervisory work, has led us to conclude that unrepresentative transaction costs in KIDs are a result of poor application of the PRIIPs methodology.

- 1.24** We will continue to work with market participants to increase understanding and ensure compliance with the PRIIPS legislation. As part of our continued commitment to engage with industry and their trade associations, we held a transaction costs seminar to highlight common errors when using the methodology. We have also included in Annex 3 an overview of a supervisory project undertaken to review existing compliance for some products with zero, negative or unduly high transaction costs. We are encouraging firms and individuals engaged in calculating transaction costs to review these findings and discuss them with us. Further action in this area could include more detailed investigations into specific firms, individuals or practices.

## Equality and diversity considerations

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- 1.25** We have considered the equality and diversity issues that may arise from this FS. Overall, we do not consider that this FS will materially impact any of the groups with protected characteristics under the Equality Act 2010.

## Next steps

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- 1.26** We will continue to work closely with the ESAs and the Commission through 2019, subject to the nature of the UK's relationship with the EU. We do have significant concerns about potentially conflicting requirements or lack of clarity about scope of application of PRIIPs requirements. We will consider the extent to which domestic interpretive guidance could mitigate our concerns around performance scenarios, SRIs and the scope of the PRIIPs legislation.

## 2 Feedback from the Call for Input

- 2.1** The Cfi closed on 28 September 2018 and we received a total of 103 responses. Respondents included investment and insurance-based product providers, trade bodies, law firms, securities exchanges and other support businesses. Respondents that provided non-confidential responses are listed in Annex 1.
- 2.2** To better understand firms' and consumers' initial experiences with the PRIIPs requirements, we asked 10 questions focusing on 4 main areas of the PRIIPs legislation: performance scenarios, SRIs, transaction costs, and the scope of the Regulations. We also asked for general comments on the PRIIPs Regulations and KID content. We have summarised the feedback based on the same 4 topics below.

### The scope of the PRIIPs Regulation

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- 2.3** Several respondents to the Cfi suggested that the scope of PRIIPs legislation is unclear for certain types of product, in particular for certain corporate bonds and Real Estate Investment Trusts (REITs). Conversely, many others expressed no concerns about the scope of the PRIIPs Regulation or believe the scope is clear, with several commenting that additional guidance and statements from the ESAs and FCA have been helpful. Some firms suggested that there should be further guidance on the scope of the PRIIPs Regulation.

### Corporate bonds

- 2.4** Several respondents raised concerns about whether corporate bonds with certain features are within the scope of the PRIIPs Regulation. There was concern that corporate issuers have been reducing new issuances of bonds in retail denomination sizes and taking steps to limit retail investors' access to their bonds in the secondary market. This is principally due to concerns about those bonds being caught by the scope of PRIIPs Regulation and the cost and potential legal risks of not producing a KID where one may be required. Evidence provided from market practitioners suggested that in some member states there had been 'more than a 60% reduction in the number and overall volume of low denomination issuances by nonfinancial corporates in the first quarter of 2018 compared to the first quarter of 2017... This recent decline comes on the back of a long-term decline in low-denomination bonds over the past 15 years'.
- 2.5** Some respondents stated that corporate issuers are concerned about the legal uncertainty as to when a KID is required, and the risks posed by the significant level of sanctions regulators could impose on issuers if a KID is not produced when required. There were also concerns regarding the practical and financial burden of maintaining the document throughout the life of a product, especially for non-financial corporate issuers.
- 2.6** Some believed that this has also affected access to corporate bonds in secondary markets for self-directed retail investors. Issuers are choosing not to produce KIDs for tranches of bonds pre-dating PRIIPs. Some retail platforms believe that these



securities might still be subject to PRIIPs requirements and are removing corporate bonds from platforms. This means retail clients may struggle to re-invest or make new investments in bonds. We understand in practice only the simplest bonds are being regarded as safely outside of scope of the PRIIPs legislation, that is, fixed coupon or zero coupon corporate bonds, and even then, provided they do not feature any clauses that could be interpreted as altering an investor's exposure. Among the clauses thought to potentially turn a corporate bond into a PRIIP are common 'make whole' or 'change of control' clauses that, in broad terms, operate to safeguard the interests of investors.

**2.7** Several respondents felt that there was potential interpretative flexibility within the current PRIIPs Regulation to permit a clarification that some of the above features of corporate bonds or simple variable coupons<sup>2</sup> would not suffice to bring a corporate bond within the scope of the PRIIPs Regulation. Those respondents suggested clarification by the European Commission was preferable, but also encouraged the FCA to consider publishing interpretative guidance. Several supported the proposals set out in the ESAs' JC letter in July 2018 to the Commission. The ESAs assessed certain corporate bond features in light of the scope of the PRIIPs Regulation and asked the Commission to confirm that they agreed with their assessment or produce similar guidance.

#### Our response

We are very concerned about the apparent impact of the PRIIPs legislation on choice and liquidity in retail corporate bond markets.

We support the position set out in the ESAs' JC letter and encourage the Commission to consider the issues fully and provide clarity.

We will consider the extent to which domestic interpretive guidance could mitigate this issue.

### Real Estate Investment Trusts (REITs)

**2.8** Several respondents stated that there was a lack of clarity and some inconsistency in the market as to whether certain REITs are treated as PRIIPs. This confusion was attributed to the fact that REITs are categorised under different listing rules (LR). Some REITs are listed (under LR 6) as commercial property companies operating a business (such as a property rental business) and some REITs are listed (under LR 15) as investment companies (such as closed ended investment funds which invest in and manage property assets).

**2.9** However, others felt the existing scope was sufficiently clear and that the manufacturers should ultimately assess whether their products are in scope. For example, the British Property Federation, representing a membership that includes REITs, stated that they supported the FCA's position set out in the Cfi. This indicated that manufacturers of these products are responsible for determining which products are within the scope of the PRIIPs Regulations.

<sup>2</sup> E.g. bonds that pay periodic interest to holders based on a variable reference rate such as the London Inter-Bank Offer Rate (LIBOR)

### Our response

It is the responsibility of the manufacturer of REITs to determine whether the REIT is a PRIIP or not, on a case-by-case basis.

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## Investment companies

- 2.10** Some respondents stated that there is an inconsistent approach being taken across the EU as to whether listed investment companies' shares are in scope of the PRIIPs Regulation. Other respondents believe that while these shares are currently considered PRIIPs, they should be explicitly ruled out of the scope of the legislation. They argue that listed investment companies are complex businesses with a diverse range of operations and so shares in them should not be considered a 'product'.

### Our response

We maintain our view that if a collective investment undertaking (that may be a listed investment company) falls within the definition of an 'alternative investment fund', and is made available to the retail market, then it should be considered a PRIIP. We do not have evidence of an inconsistent approach being adopted across the EU. However, subject to the nature of the UK's relationship with the EU, we will continue to work with our EU counterparts and address any emerging inconsistencies through our work with the ESAs.

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## Products manufactured or sold outside the EEA

- 2.11** Some respondents thought the obligation to provide a KID did not apply to products manufactured outside of the EEA, even if the product is sold within the EEA. We were also told that some distributors have assumed that where a KID is not available for a non-EEA originated investment product, then it is not a PRIIP. Other market participants have assumed that if a product does not have a KID, it cannot be sold to EEA clients.
- 2.12** One respondent believed that U.S. fund manufacturers are unable to produce KIDs due to the requirement to include performance scenarios - which may be illegal under U.S. regulation. These funds were no longer being made available to EEA residents from January 2018.
- 2.13** Other respondents queried whether a KID is required for a PRIIP manufactured within the EEA, but exclusively sold to retail clients outside of the EEA.

### Our response

Any PRIIP sold in the EEA or made available to a retail client in the EEA requires a KID to be produced and provided to the prospective investor, unless a product is targeted at professional clients only.

For products manufactured within the EU but only made available to retail clients outside the EEA, the European Commission has previously clarified that: 'Where a PRIIP is only made available to investors outside the Union, a KID is not required' (Commission guidelines on the PRIIPs Regulations ([C 218/12](#)) published in 2017).

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## Miscellaneous products

- 2.14** Some respondents expressed a view that Foreign Exchange (FX) Forwards and FX Swaps, among other derivative products, do not meet the PRIIPs definition. This is said to be because the instruments are used to fix the cost of the underlying asset for a retail investor, therefore the amount repayable is known at the outset and not subject to fluctuations.
- 2.15** One respondent stated that there was no specific exemption for Individual Savings Account (ISA) wrappers in the PRIIPs Regulation and that there was an inconsistent approach as to whether a KID is required.
- 2.16** Two respondents raised concerns about the scope of application of the PRIIPs Regulation for model portfolios, especially those with a narrow mandate where the underlying assets are not PRIIPs.

### Our response

FX Forwards and FX Swaps are derivatives. As explained in [our website](#), we consider that derivatives, if offered to retail investors, would fall within the definition of PRIIPs.

We stated in PS 17/06 that an ISA wrapper is not itself an investment. So, it cannot be a PRIIP, though the assets held within it often are. We have now explicitly included ISA wrappers in our [‘What is not a PRIIP’ list](#). However, we remind firms that any costs or charges associated with the provision of the ISA tax wrapper need to be disclosed in a separate document (see COBS 6.1.9R).

We also stated in PS17/06 that the provision of a service that allows retail investors to purchase, hold and sell investments as legal or beneficial owner, is unlikely, itself, to be a PRIIP. This would also include non-fund model portfolios. However, a firm would need to provide relevant disclosure material, such as a KID, for any individual products purchased by or on behalf of a retail client as part of an investment service.

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## Client classification

- 2.17** Two respondents stated that there was ambiguity about whether transactions with High Net Worth (HNW) retail investors were, or should be, exempt from the PRIIPs Regulation. This relates to FCA financial promotion rules that allow specific subsets of retail clients to be excluded from marketing restrictions applied to certain types of product (see COBS 4.12). These respondents suggested that this sub-set of clients did not require a KID and the time delay that could arise from having to provide a KID pre-trade are not in the best interests of this investor client base.
- 2.18** We also received reports that some private equity and venture capital funds were no longer marketing to HNW individuals due to the requirement for a KID and the administrative burden of opting-up investors to be ‘elective’ professional clients. This relates to client categorisation requirements under COBS 3.5, which are derived from MiFID II. Proposed solutions included exempting semi-professional investors as defined by the European Venture Capital Funds Regulation. Alternatively, the FCA

could clarify that a PRIIP should only be considered 'made available' to retail investors when the PRIIP is widely distributed (eg to more than 150 retail investors per member state).

- 2.19** One respondent noted that the reclassification of local authorities and municipalities from professional clients to retail clients by default under MiFID II has led to a re-consideration of the target market for products previously identified as appropriate for professional clients only. Where certain products were previously deemed to be outside the scope of the PRIIPs legislation (as they were targeted only at professional clients), these could now be within scope and require a KID if sold to local authorities as retail clients.

### Our response

The scope of the PRIIPs Regulation is based on the definition of retail client under EU law and does not exclude any subset of retail client. For example, those who may be classified as HNW or sophisticated for the purposes of certain domestic financial promotions rules. Therefore, a product will be a PRIIP and require a KID if made available to any retail client within the EEA. We also expect the KID to provide a useful source of information even to wealthier or more sophisticated retail clients in some cases. It remains a commercial decision for firms as to whether they choose to produce a KID in order to allow retail clients to access their products, or alternatively choose to limit the availability of their products to non-retail clients. This is the case both for private equity and venture capital products, and products previously sold to local authorities classified as professional clients prior to MiFID II. We remind firms that, before deciding to accept a request for re-categorisation as an elective professional client, a firm must take all reasonable steps to ensure that the client satisfies the qualitative test and, where applicable, the relevant quantitative test. In addition, if a firm becomes aware that a client no longer fulfils the initial conditions that made it eligible for categorisation as an elective professional client, the firm must take the appropriate action. If the appropriate action involves re-categorising that client as a retail client, the firm must notify that client of its new categorisation. The relevant Handbook provisions are in COBS 3.5.3R to 3.5.9R.

### PRIIPs where a KID is not made available

- 2.20** Several respondents stated that it was not always clear if a KID was not provided because the product is not a PRIIP, or because the product is not being made available to retail clients. This can be challenging for distributors that must ensure that a KID is provided to retail clients, and so must check with a manufacturer whether they deem their product to be a PRIIP. This includes cases where the definition for a PRIIP is considered unclear, such as REITs (see above). Some respondents requested a central register of all KIDs to be established and held by the regulator using the ex-ante (before the event) notification powers available to National Competent Authorities in Article 5(2) of the PRIIPs Regulation.

### Our response

We appreciate the challenge for distributors in clarifying whether a product without a KID is a PRIIP. However, we have no plans to establish a central register of PRIIPs and do not believe it is unreasonable to check with the manufacturer about whether the product is a PRIIP.

## Costs, including transaction costs

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- 2.21** Many respondents to the Cfl raised concerns with the methodology and display of transaction costs in the KID, in particular where the methodology results in negative, zero or very high transaction costs. They argued that this outcome is unlikely to fairly represent the true transaction costs of the product. Several respondents raised concerns that firms are applying the transaction cost rules in different ways, making comparison difficult for consumers. Several respondents reported no issues with transaction costs and believed they had improved the disclosure of costs for consumers.
- 2.22** After reviewing the responses to the Cfl, we hosted a seminar on transaction costs to support firms with their compliance activities for these requirements.

### The slippage methodology

- 2.23** Slippage is the difference between the price at which a trade is executed and the 'arrival price' when the order to trade is transmitted to the market. It captures the bid-ask spread, as well as what is called the market impact, which is the effect that an order has on the price during the time that it is in the market. It assumes that any element of market fluctuation during the time that the order is being executed is random. The PRIIPs legislation requires slippage to be calculated across all transactions for a product over a 3-year period. When slippage is calculated over many transactions, this random element should average out to approximately zero.
- 2.24** Some respondents raised concerns that the slippage methodology can, in some cases, lead to negative transaction costs. Several respondents said they had seen negative transaction costs published in KIDs. However, no response contained full transaction-level calculation data for a portfolio over 3 years of transactions to substantiate the claim that the methodology is not working as expected or intended. We did receive examples of individual transactions where respondents argued that the costs appear anomalous. Some respondents argued that traders who use a Volume Weighted Average Price (VWAP) strategy are unfairly penalised by having to disclose slippage costs. Others argued that slippage leads to fluctuations in cost over time. Several respondents raised concerns that price availability for some securities, in particular some bonds, is poor.

### Our response

We appreciate that some firms have concerns with the method for calculating transaction costs. As we set out in the Cfl, we undertook supervisory work in this area, identifying data issues and calculation errors. We received limited amounts of data in response to the Cfl, and what we received was not detailed enough for us to see if apparent anomalies are the result of issues with the methodology or with similar data issues and calculation errors.

Slippage relies on the availability of prices when orders are sent to be transacted. We accept that price availability is variable across securities, in particular for over-the-counter transactions in bonds.

Slippage, as required by the PRIIPs Regulation, is not intended to be an accurate measure of transaction costs for each individual transaction. For each individual transaction, slippage includes both the transaction costs incurred and any market movements while the transaction has been taking place. The assumption behind slippage cost is that short-term market movements are random, and that, at the level of a portfolio, when these random components are added together they should be close to zero.

The measurement of slippage cost should not substitute firms' obligations under best execution rules. Using the slippage methodology to calculate transaction costs for disclosure should not force firms to consider this as the only or best way to monitor best execution.

Slippage does not lead to perfectly stable output over time. Transactions costs fluctuate over time, and investment vehicles undertake different volumes of transactions over time.

We are concerned about the examples we have seen of poor compliance with the requirements. Findings from our supervisory work are being fed back to industry on the [FCA website](#). We have also conducted a transaction cost seminar for firms to highlight the issues we have found. In Annex 3, we set out some common errors seen in the methodology. We are encouraging firms and individuals engaged in calculating transaction costs to review these findings and discuss them with us. Further action in this area could include more detailed investigations into specific firms, individuals or practices.

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## Transaction cost presentation

- 2.25** Some respondents felt that the presentation of transaction costs was too complicated for an ordinary retail investor, or was likely to be misinterpreted. They felt that very few investors are likely to find it straightforward to understand the difference between the transaction costs element and the rest of the charges.

### Our response

The presentation of transaction costs within the KID are prescribed by EU legislation. We will consider this feedback as we engage with the EU institutions on the forthcoming review of the Regulation.

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## Other cost issues: interest costs

- 2.26** Several respondents raised concerns that there was uncertainty and inconsistency across industry as to exactly what information goes into the calculations for costs. Particular concerns were raised regarding property or infrastructure investment trusts, where some are including interest costs, but others are not.

### Our response

We are continuing to supervise how firms are applying the cost methodologies when producing their KID and we have fed into work at European level on this issue using the evidence received in the CfI.

## Fund-of-funds look-through

- 2.27** Some respondents raised concerns that there is a lack of clarity as to which products require a look-through and how many layers of vehicles a manager should look-through for fund-of-funds. It has been reported to us that some managers only look at the first level, while others go further. Some have reported that this leads to inflated costs in the KID, due to the costs of the PRIIP and the costs of the underlying funds being reported in the KID, with costs largely increased due to the inclusion of incentive fees of the underlying investments.

### Our response

The requirement in the PRIIPs regulation is to disclose all direct and indirect costs, including those of underlying investment products. Where a PRIIP invests in other PRIIPs, the summary cost indicators of those products should contain information about the costs of their own underlying investments. The top-level PRIIP manufacturer must include these in its own calculation of costs. The relevant requirements are set out in the PRIIPs RTS, Annex VI at 5(l), (m) and (n).

## Summary Risk Indicators

- 2.28** Some respondents raised concerns that the SRI methodologies were delivering results that they believed to under-estimate the risk of the product. However, several respondents had no concerns with the SRI section of the PRIIPs KID. There were many issues raised with the presentation of the SRI and the description used. There were some concerns that the SRI did not adequately capture all risk associated with a product.

## Comparing PRIIPs with UCITS funds

- 2.29** Several respondents commented that the SRI required within the PRIIPs KID is too similar to the Summary Risk and Reward Indicator (SRRRI) scale required in the UCITS Key Investor Information Document (KIID), since both indicators use a scale of 1-7. Respondents consider this to be confusing for investors since they use slightly different methodologies, and as a result a KIID for UCITS funds which invests in similar assets to a PRIIP appear to deliver a different (higher) SRRRI score than the PRIIP's SRI. Respondents told us this may also create a competition distortion which could be made worse by other issues raised with the PRIIPs KID such as over-optimistic performance scenarios (see below).

### Our response

The UCITS exemption is set out in the PRIIPs Regulation and is expected to be extended to 2021 following the conclusion of trilogues between the European Commission, Council and Parliament. The original exemption reflected a clear policy decision by the Commission and ESAs to ensure the PRIIPs SRI could accommodate a broader range of products subject to the PRIIPs legislation, in contrast to the narrower scope of the UCITS Directive. We are aware of concerns regarding the potential comparability of the PRIIPs KID and UCITS KIID by investors and have shared these concerns with the ESAs.

## Description of other risks

- 2.30** Many respondents raised concerns about the prescribed nature of the text accompanying the SRI score. They believed the 200-character limit for the text was inadequate to explain all other significant risks not covered in the SRI score calculations, and that the text limit is lower than is allowed on the UCITS KIID. There were also a few respondents who felt that the expression 'summary risk indicator' was itself misleading as it did not summarise all of the risks related to the product. We also received information that some manufacturers were using this section to link to their prospectus, instead of describing the other risks involved.

### Our response

We agree that the description accompanying the SRI could be longer to allow a better or more complete summary of key risks. This was recognised by the ESAs in their targeted review Consultation Paper, where they proposed to increase the character limit to 300-characters. This increased limit would better help firms describe the additional risks of a PRIIP for consumers. Although the ESAs did not recommend this change in their Final Report, they are continuing to consider if clarification via a level 3 measure would be relevant before the conclusion of a review of the KID.

Firms should also ensure descriptions of risks are clear and appropriate for retail clients, and do not simply link to, or replicate language used in a prospectus if this would not be easily understood by less sophisticated clients. We encourage firms to make full use of the 'what is this product' section of the KID. Better explanations of the product will benefit consumers' understanding of what they are investing in.

## Inappropriate risk scores and methodological concerns

- 2.31** Some respondents to the CfI viewed SRIs as potentially misleading due to some assets being allocated what they believe to be an inappropriate risk rating under the methodology. One respondent submitted findings from their own research that showed 70% of VCT investments had an SRI score of 3 (medium-low risk). This could be interpreted by consumers as a product which is unlikely to lose money, whereas these products are widely considered to be high risk. They believed that as VCTs often make speculative investments in smaller, unquoted and/or young companies, they are generally considered high risk investments in the industry. These risk scores result



from the SRI methodology mainly relying on price volatility, which is less relevant to some products. Other products, such as for example securities issued by investment companies, were deemed by some respondents to be rated lower risk than alternative structures thought to be comparable in risk.

**2.32** There were some concerns raised with specific elements of the SRI calculation methodology. This included all derivatives being rated with a score of 7, which some believed was too high and restrictive. A few respondents raised concerns with the Credit Risk Measure (the Market Risk Measure Class assigned according to the Value-at-Risk equivalent annualised Volatility). They felt that there can be some inconsistencies between the SRI for broadly similar products, such as VCTs and enterprise investment schemes, depending on whether the product has a frequently available published price. Some of the methodological concerns raised in the CFI were also acknowledged in the ESAs' targeted review Consultation Paper.

### Our response

The PRIIPs RTS is prescriptive in how the SRI should be calculated for a PRIIP and we believe that this methodology works well in most cases. We recognise that the methodologies rely primarily on volatility and do not reflect all the risks that may apply and agree this can lead to misleading SRIs for some types of investment product. As a result, less liquid products such as VCTs are rated as lower risk than we would expect them to be. This is because such products have fewer observable prices historically, as they are only periodically valued, and are not constantly priced and traded.

Generally, we share the concerns of industry that some products appear to be rated as lower risk than alternative structures with similar underlying assets. We have used the information received in the CFI regarding methodological concerns to influence our discussions at a European level and it will be considered in our future approach.

While some products with seemingly misleading SRI ratings, such as VCTs, may have little retail participation, it is important that the SRI accurately represents the risk of the product.

We will continue to work closely with ESAs and the Commission through 2019 (subject to the nature of our relationship with the EU following exit day) to address these concerns. We will consider the extent to which domestic interpretative guidance could mitigate this issue.

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## Performance scenarios

**2.33** The performance scenarios required by the PRIIPs KID were the main focus and raised the greatest concerns for the majority of respondents to the CFI. There was widespread concern that performance scenarios are flawed due to their reliance on past performance. Respondents said that this has led to overly-optimistic figures on

the potential returns a consumer could expect for almost all asset classes in KIDs, reflecting the strong performance of the market over the previous 5 years. Many respondents expressed the view that performance scenarios were fundamentally misleading for retail investors, created a conflict with other regulatory requirements on firms<sup>3</sup>, and had the potential to cause a future mis-selling scandal.

### Performance scenarios are over-optimistic and misleading

- 2.34** Many respondents felt that the performance scenario methodologies lead to over-optimistic results due to the recent strong gains made in the market over the previous 5 years. This impact appears to be particularly acute for alternative investment funds and investment trust companies, where respondents stated they believed that the PRIIPs Regulations were forcing them to misrepresent their products. The pro-cyclical nature results from the performance scenarios being based on past performance data to estimate future returns.
- 2.35** Many respondents believe that consumers read this information as predictions based on past performance, potentially causing consumers to invest in products that are not suited to them. One response to the Cfi included data that showed for a number of the largest and most widely-held funds in the investment company sector, KIDs were displaying largely positive returns even in the unfavourable scenario over the 5-year Recommended Holding Period (RHP).
- 2.36** Several respondents to the Cfi suggested that the pro-cyclical nature of performance scenarios was exacerbated by the 5-year calculation window. Several respondents suggested that this calculation period could be extended to 10 or more years to capture a full economic cycle and better represent potential returns for the PRIIP.
- 2.37** Many respondents stated that past performance should not be the basis for the performance scenario as it contradicts the standard disclosure line that past performance is no indication of future performance. Many respondents believed that the existing narrative disclosure was too short and small to impact the way consumers were interpreting the performance scenarios.

#### Our response

We share the concerns of respondents to the Cfi that for many asset classes, performance scenarios can appear over-optimistic and are pro-cyclical in nature. We issued a [statement](#) in January 2018 to address some of these concerns, saying that we would be comfortable with providers including additional material with their KID to explain to investors how performance scenarios were calculated and any concerns they may have. The ESAs have since [published a Supervisory Statement](#) that recommends the inclusion of an additional, highlighted warning of the performance scenarios' limitations.

We share the concerns of industry that past performance is not a reliable indicator of future results. The performance scenarios in the PRIIPs KID are intended to give investors a range of scenarios that indicate what they may receive as a return on their investment. We have been working constructively with the ESAs' JC to explore improvements to the presentation of performance scenarios and their methodologies to ensure that consumers interpret the information provided as originally intended. There was an acknowledgement in the consultation that there

<sup>3</sup> For example, firms' obligations under COBS 4 and Principle 7 to ensure information provided to clients is clear, fair and not misleading.

are serious concerns with performance scenarios that will need to be addressed in the full review by the end of 2019.

The proposal to extend the calculation window was explored in the ESAs' JC's targeted review Consultation Paper but has several disadvantages. Market cycles can last for ten years or more and extending the historical period also increases the number of products for which data will not be available for the whole period. It was assessed in the Final Report that this option's disadvantages outweighed its benefits and this view was supported by most respondents to the ESA's consultation.

The FCA supports the work being done at EU level and will monitor any changes to performance scenarios that result from this work. We will consider the extent to which domestic interpretative guidance could mitigate this issue.

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### **KID should display historic performance**

- 2.38** Some respondents wanted performance scenarios to either be replaced or accompanied by a display of past performance, as is currently used with the UCITS KIID. These respondents believed that consumers were already familiar with this concept and it did not deliver projections which could be considered an expectation of return. This approach was generally favoured by fund bodies, who feel that the results better reflect the skill of the fund manager. If this information was supplied alongside performance scenarios, some respondents believed it would add context to the performance scenarios and temper any over-optimistic projections against past returns.

#### **Our response**

This approach was considered both during the original implementation of the PRIIPs regime and again by the ESAs in their targeted review, including consideration of simulating past performance where this information was not available. Following feedback to the consultation, the ESAs decided not to propose these amendments in the targeted review, but instead to consider if and how to include presentation of past performance data in the full review of the PRIIPs Regulations.

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### **Recommended holding period (RHP)**

- 2.39** Some respondents raised concerns with the requirement for annualised RHP, particularly for short dated products like derivatives. Experience of the existing performance scenarios is that they can show annualised returns running into thousands of percentage points. There were also some responses that questioned how products with 'autocallable' features, which allow for an investment product to be called by the issuer before maturity, should be presented in the performance scenarios table. There were also concerns raised for products with a RHP of over 10 years, where the over-optimistic nature of the performance scenarios are further exaggerated. Some respondents also raised concerns about the comparability of KIDs when products were using different RHPs.

### Our response

In July 2018, the ESAs Q&A ([JC 2017 49](#)) was updated to address products with a RHP of less than 1 year. This clarified that the RHP can be displayed in days and months and for 'average return each year' to be replaced with 'percentage return'. It also suggested that firms make better use of the 'what is this product' section of the KID to explain that the PRIIP is a short-dated product with a short RHP and that this will affect the comparability of this KID with other KIDs.

The ESAs targeted review CP ([JC 2018 60](#)) acknowledged the concerns of industry about PRIIPs with an autocallable feature. It suggested that Level 2 requirements (set out in the RTS) could be amended so that, where the product is called or cancelled before the end of the RHP according to the simulation, performance would only be shown at the intermediate holding periods up to the call or cancellation. The effective holding period should then be used to calculate the average annual return. Further, where the product is called or cancelled according to the simulation at a time which does not coincide with an intermediate holding period, the performance at the call or cancellation date would be shown at the subsequent holding period. Examples of these changes to the table and additional descriptions to illustrate the approach were included in the Consultation Paper. The ESAs have committed to further exploring these amendments in their final review due before the end of 2019.

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## Technical methodological issues

- 2.40** Several responses raised technical issues with the performance scenario methodologies. This included issues with the discount method for an intermediate holding period, issues with the trend definition in the scenarios for Category 3 products, and with the Credit-linked note credit impact clarification.

### Our response

These issues require intervention at a European level to be corrected or addressed. We will raise them in our ongoing work with the Commission and ESAs as they undertake the review of the PRIIPs legislation and support action to address these technical issues.

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## General comments

- 2.41** Many respondents used the general comments to highlight their view that the KID is generally misleading or unhelpful to consumers, or that the information within could be better found elsewhere. Some respondents found that the translation costs and

requirements were too high when made available in multiple member states and that it could be difficult to fit the KID within the page limit, especially once translated into other languages. Many felt that the KID's prescribed descriptions were too prescriptive throughout the KID.

### **Concerns that the KID may be misleading, unhelpful or unclear**

- 2.42** Many respondents stated that they felt the KID was generally unhelpful or unclear for retail consumers and that they were aware of financial advisers recommending that advised clients largely ignore the information contained within. These comments focused on the misleading performance scenarios and products where the SRI appeared to underestimate the risk of a product. There was also feedback that investors only pay attention to the performance scenario and SRI figures, and not to important information elsewhere. Some respondents stated that the KID had improved disclosure standards and made it easier for investors to understand the product.
- 2.43** Some respondents believed that, despite its goals, the KID provides too much technical information for an ordinary retail investor to fully comprehend, including details in the breakdown of the transaction costs. Some respondents also believed that the information found in the KID could already be found elsewhere, such as in the prospectus, and that it was better presented there.
- 2.44** As mentioned previously, many respondents felt that the descriptions required by the PRIIPs Regulations in the KID are too prescriptive or too short to adequately explain the risk and reward profile of the PRIIP. Some respondents felt that the descriptions should be more free-form so that manufacturers can ensure investors fully understand their investments.

### **Our response**

We believe that the KID is useful for investors and that consumers will benefit from the information in it. The consumer testing undertaken before implementation of the Regulations indicated that the KID format presented information in a way that investors found helpful. The ESAs have indicated that there will be some further consumer testing as part of the full review of the Regulations.

The KID is designed to offer a comparable summary of a PRIIP and not to be an extensive summary that should be studied in isolation. It is important that investors consider all the information they receive before making an investment decision. The KID brings together some of the more important elements of a PRIIP so that it can be compared against other, similar products.

The ESA targeted review CP proposed to extend the character limit for the description accompanying the SRIs so that manufacturers can better describe all other significant risks and this is continuing to be considered in their future work. We also believe that firms have not been making full use of the 'what is this product' section of the KID, and that better explanations of the product will also benefit consumers' understanding of what they are investing in.

We have discussed above those areas where we feel certain requirements under the Regulations are giving rise to unintended results. We have outlined our next steps where that is a concern.

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### Translation and associated costs

- 2.45** Several respondents highlighted that the cost of translating the KID for each Member State that they make their product available to is a barrier to trading across the single market. Further, the translation of the KID can sometimes lead to the resulting KIDs exceeding the page limit and that there should be an exception for this when the original KID is within the requirements.

#### Our response

It is a requirement of the PRIIPs Regulations that the KID fits within the 3-page limit so that the information is presented to investors in a short, concise and standardised format. These aims could not be achieved without translating the KID where the product is made available to retail investors in Member States where different languages are spoken. We appreciate there may be practical difficulties in some circumstances and have shared this feedback with the ESAs and Commission.

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### UCITS exemption

- 2.46** Many respondents raised concerns that the UCITS exemption can lead to investor confusion given the similarities between the PRIIPs KID and UCITS KIID, and that consumers may compare them inappropriately. Some respondents also believed that the UCITS exemption should be extended until the issues with the KID have been addressed.

#### Our response

The UCITS exemption is set out in the PRIIPs Regulation and is expected to be extended to 2021 following the conclusion of trilogues between the European Commission, Council and Parliament. The ESAs intend to complete a review of PRIIPs and address any issues with the PRIIPs KID before the exemption expires. We are aware of concerns regarding the potential comparability of the PRIIPs KID and UCITS KIID by investors and have shared these concerns with the ESAs.

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### Financial promotions

- 2.47** Several respondents raised concerns that some manufacturers or distributors may, or are, using the information within the KID as selling points. This is especially of concern to some respondents when the SRI in the KID is considered to underestimate the risk of a product, or where it produces overly-optimistic performance scenarios.

#### Our response

A financial promotion must be compliant with regulatory requirements; information drawn from a KID is not exempt from such requirements. In

particular, information from the KID might cause a promotion to be unfair or misleading to the consumer, in breach of FCA rules, where it is read in isolation from descriptions. This is a particular risk where the information being used as a selling point comes from overly optimistic performance scenarios or potentially unrepresentative SRIs.

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## Other concerns

**2.48** Other issues raised in response to the Call for Input included the following concerns:

- Advisers and platforms were not doing more to encourage investors to read the KID before making an investment.
- The cost of compliance with the PRIIPs Regulations was high.
- There were perceived inconsistencies between the PRIIPs Regulations and other disclosure requirements.

### Our response

A distributor of a PRIIP must ensure that they provide the KID to the retail investor in good time, before the transaction is legally binding. Firms should ensure that the KID is available on their website and is not placed in an obscure location that would be difficult to find.

The KID aims to improve consumer understanding of outcomes by standardising the disclosures retail investors receive, giving them the ability to compare products. We support this objective of the Regulation. While compliance with the PRIIPs Regulations will incur costs, there is a clear benefit to consumers in having this information.

The PRIIPs legislation was designed to harmonise disclosure requirements across the products within scope. Firms are subject to further disclosure requirements for their MiFID business, and currently UCITS funds are subject to the UCITS disclosure regime. We will continue to monitor any perceived inconsistencies between the PRIIPs Regulations and other disclosure requirements and feed them back to the Commission and ESAs to be considered.

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## 3 EU developments

- 3.1** There have been significant developments with the PRIIPs Regulation at EU level since the CFI was published. The ESAs JC has published and concluded a targeted review of performance scenarios in a [Consultation Paper](#), with a view to this now feeding into a full review during 2019. This followed the [European Parliament's recommendation in late 2018](#) to extend the UCITS exemption from PRIIPs until the end of 2021 and extend the time allowed for the ESAs to complete their full review of the PRIIPs Delegated Regulation to the end of 2019, which has been agreed in trilogues with the Commission and Council.

### ESAs Joint Consultation

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#### Context

- 3.2** On 8 November 2018, the ESAs published a Joint Consultation Paper (JC 2018 60) concerning amendments to the PRIIPs KID. This followed a letter from the ESAs to the European Commission stating that amendments to the PRIIPs regime were needed. The Joint Consultation Paper proposed targeted amendments, principally to performance scenario-related requirements, in a short, 4-week consultation window in order to meet the timetable for change that was envisaged at that time.

#### Joint Consultation Paper

- 3.3** The amendments proposed in the Joint Consultation Paper attempted to address the issues with the performance scenarios being overly-optimistic or misleading to consumers. The key proposal was the potential inclusion of historic performance data in the KID alongside the existing performance scenarios. Some PRIIPs do not have historic performance data but would need to display information to ensure harmonisation of KIDs across the Regulations. It was suggested that these PRIIPs could simulate past performance based on the performance of underlying assets. There was concern that retail investors may unduly rely on past performance information and assume it will be replicated in the future.
- 3.4** An alternative option presented in the Joint Consultation Paper included anchoring the performance scenarios in the risk-free rate of return. This would change the methodology to derive future performance scenario figures so that the expected performance for the assets underlying a PRIIP would be the risk neutral expectation based on the expected values of interest rates and all relevant cash flows. It was anticipated that this would remove the risk that performance scenarios are 'misleading'. It was considered that the information could be seen as less useful for retail investors to compare between different PRIIPs as this approach does not discriminate between different asset classes. There were also concerns about access to market data, particularly for smaller manufacturers.
- 3.5** The third option for performance scenarios put forward by the ESAs was to amend the approach and presentation of the scenarios to highlight the range of outcomes. This could be done by removing the moderate and unfavourable scenarios in a manner that



indicates a range of possible outcomes. This attempted to prevent consumers from thinking that only a limited number of outcomes were possible and prevent them from assuming that the moderate scenario was the most likely outcome. It also explored the option of changing the presentation of the data in the KID to a graph, rather than the existing table. The report suggested that this approach may not reflect clearly the range of outcomes for certain PRIIPs and it may be difficult for retail investors to understand.

**3.6** Finally, the Paper considered extending the historical period used to measure performance when applying the methodology from 5 years to 10 years. This would reduce the overly optimistic returns of existing KIDs for a short amount of time by capturing performance information from the 2008–2009 financial crises, but would not address market cycles that last longer than 10 years. This approach was regarded as not suitable, especially as the data from the financial crisis would not have applied to KIDs reporting from 2019–2020.

**3.7** The Paper also included other specific amendments to the Market Risk Measure calculation for regular investment or premium PRIIPs, products with an autocallable feature. Specifically, extending the character limit for the SRI narratives, changing the narrative for performance fees in the composition of costs table, and changes to the growth assumption for the reduction in yield calculation.

### Final Report

**3.8** The ESAs Final Report was published in January 2019 and indicated that stakeholders did not support the targeted amendments proposed in the Joint Consultation Paper. The Paper also took into account the latest information from discussions between the co-legislators on the application of the KID by UCITS and relevant non-UCITS funds and the timing of a review of PRIIPs. The ESAs therefore decided not to propose amendments at this stage and instead to work to provide more input into a more comprehensive review of the PRIIPs legislation envisaged to take place during 2019. The Final Report also included a Supervisory Statement that the ESAs published following the consultation to strengthen the warnings accompanying performance scenarios.

### Other EU developments

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**3.9** On 3 December 2018, the European Parliament Committee on Economic and Monetary Affairs (ECON) adopted amendments to the PRIIPs Regulation, which would provide for a review of PRIIPs by 31 December 2019, and an extension of the UCITS exemption until 31 December 2021. These amendments were adopted in the Report on the Regulation on facilitation cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013 and (EU) No 346/2013. The amendments are expected shortly to be adopted following trilogues between the European Parliament, Commission and Council.

## 4 Next steps

- 4.1** Following the publication of this FS we will continue to work closely with the Commission and the ESAs, as far as we are able, to influence the full review of the PRIIPs Regulation, anticipated to be completed by the end of 2019. In particular, this will focus on the performance scenarios, SRIs and market impacts arising from uncertainty about whether certain corporate bonds fall within the scope of the PRIIPs Regulation.
- 4.2** We will also continue to monitor the impact of the PRIIPs regime and investigate the scale of potential consumer harm in this area of the market. We will work constructively with trade bodies, consumer groups and firms in the industry to ensure that PRIIPs delivers the intended outcomes for consumers.
- 4.3** We do have significant concerns about potentially conflicting requirements or lack of clarity about scope of application of PRIIPs requirements. We will consider the extent to which domestic interpretative guidance could mitigate some of these issues.
- 4.4** The PRIIPs Regulation will be onshored under the EU Withdrawal Act at the point of the UK's exit from the EU. We have worked closely with HMT and have consulted on the consequential amendments required to ensure that the regime continues to function post exit point.

## Annex 1

# List of non-confidential respondents

Aberdeen Asian Income Fund Ltd

Aberdeen Frontier Markets Investment Company Plc

Aberdeen Latin American Income Fund Ltd

Aberdeen New India Investment Trust Plc

Aberdeen Standard European Logistics Plc

Aberdeen Standard Investments

Acorn Income Fund Ltd

AEW UK Investment Management LLP

AJ Bell

Allianz Trust Plc

Alternative Investment Management Association (AIMA)

Asian Total Return Investment Company Plc

Association for Financial Markets in Europe (AFME)

Association of British Insurers (ABI)

Baillie Gifford Group

Better Finance

Blackrock

British Private Equity & Venture Capital Association (BVCA)

British Property Federation (BPF)

Brunner Investment Trust Plc

BVI (German Fund Association)

BWB Compliance

Capital Gearing Trust Plc

City of London Law Society Regulatory Law Committee

Company RiskSave Technologies  
DMS Governance Risk and Compliance Services  
Ediston Properties Ltd  
Ediston Property Investment Company Plc  
Enterprise Investment Scheme Association (EISA)  
FCA Consumer Panel  
FCA Practitioner Panel  
Financial Express  
Foreign and Colonial Global Smaller Companies Plc  
Foreign and Colonial Investment Trust Plc  
Frostrow Capital LLP  
Guy MacNaughton  
Hansa Trust Plc  
Helford Capital Partners LLP  
Henderson European Focus Trust Plc  
Henderson High Income Trust Ltd  
IG Markets Ltd  
Integrated Financial Arrangements Ltd  
Interactive Brokers (U.K.) Ltd  
Interactive Investor Services Ltd  
International Capital Market Association (ICMA)  
Invesco Income Growth Trust Plc  
Invesco Perpetual Select Trust Plc  
Japan Growth Fund Plc  
Johnston Carmichael LLP  
JP Morgan Asset Management  
Keystone Investment Trust Plc

Killik & Co

London Metal Exchange

Lowland Investment Company Plc

Martin Currie Asia Unconstrained Trust Plc

Martin Currie Global Portfolio Trust Plc

Martin Currie Investment Management Ltd

Morningstar UK Ltd

Old Mutual Wealth Life and Pension Ltd, and Old Mutual Wealth Ltd

Pantheon Ventures LLP

Perpetual Income and Growth Investment Trust Plc

Personal Assets Trust Plc

Personal Investment Management & Financial Advice Association (PIMFA)

Polar Capital LLP

Premier Global Infrastructure Trust Plc

Prestbury Investments LLP

Robin Archibald

RW Blears LLP

Schroder Investment Management Ltd

Securities Industry and Financial Markets Association Asset Management Group  
(SIFMA AMG)

Securities Trust of Scotland Plc

Seneca Global Income and Growth Trust Plc

Shires Income Plc

St. James's Place Plc

Standard Chartered

Stefan Graf

The Association of Investment Companies

The City of London Investment Trust Plc

The European Fund and Asset Management Association (EFAMA)

The Investment Association (IA)

The Merchants Trust Plc

The North American Income Trust Plc

The Scottish Oriental Smaller Companies Trust Plc

Threesixty services LLP

TR Property Investment Trust Plc

UK Finance

UK Structured Products Association

VinaCapital Vietnam Opportunity Fund Ltd

## Annex 2

### Abbreviations used in this paper

<b>Cfi</b>	Call for Input
<b>ECON</b>	European Parliament Committee on Economic and Monetary Affairs
<b>EEA</b>	European Economic Area
<b>ESA</b>	European Supervisory Authority
<b>EU</b>	European Union
<b>FCA</b>	Financial Conduct Authority
<b>FS</b>	Feedback Statement
<b>FSMA</b>	Financial Services and Markets Act (2000), as amended
<b>FX</b>	Foreign Exchange
<b>HNW</b>	High Net Worth
<b>IC</b>	Investment Company
<b>ISA</b>	Individual Savings Account
<b>JC</b>	Joint Committee
<b>KID</b>	Key information Document
<b>KIID</b>	Key Investor Information Document
<b>LR</b>	Listing Rules
<b>MiFID II</b>	Markets in Financial Instruments Directive (2014/65/EU)
<b>PRIIP</b>	Packaged Retail and Insurance-Based Investment Product
<b>PRIIPs Regulation</b>	Regulation (EU) No 1286/2014
<b>PS</b>	Policy Statement
<b>REIT</b>	Real Estate Investment Trust
<b>RHP</b>	Recommended Holding Period

<b>RTS</b>	Regulatory Technical Standard
<b>SRI</b>	Summary Risk Indicator
<b>SRRI</b>	Summary Risk and Reward Indicator
<b>UCITS</b>	Undertaking for Collective Investment in Transferable Securities
<b>VCT</b>	Venture Capital Trust
<b>VWAP</b>	Volume Weighted Average Price

We have developed this Feedback Statement in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

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## Annex 3 Overview of Supervision Project on Transaction Costs

### Background

MiFID II and PRIIPs came into force in January 2018 with the aim of enhancing transparency. PRIIPs directly impacts asset managers in terms of costs and charges disclosures for in-scope products. MiFID II brought in new costs and charges disclosure requirements that distributors were required to adhere to, which means asset managers need to calculate and share cost information to enable intermediaries to comply with the directive.

Following the introduction of these new rules, we conducted a diagnostic review to assess firm conduct, whether these firms complied with the regulations and also whether they complied with the spirit of the regulation by being fair, clear and not misleading.

If customers do not have access to clear and correct information, they will not be able to compare products, which could result in harm since they will be making uninformed investment decisions and could be unaware as to how much they are being charged.

### What we did

The project requested MiFID II and PRIIPs transaction cost calculation methodologies and the underlying trade data for 16 investment products. Firms managing these ranged from small independents to large multinationals and the products spanned some for which PRIIPs KIDs are being produced and others for which a UCITS KIID was being prepared. For these UCITS products, transaction costs are calculated and then given to distributors, who need them to meet MiFID II cost disclosure requirements. The project then reviewed the transaction cost calculations using the raw data provided and looked for discrepancies or errors and their resulting impact on transaction cost calculations and disclosure.

### Observations

Most of the asset managers assessed calculate transaction costs in compliance with the relevant requirements. However, we identified problems with several of the firms and products sampled. These issues increase the risk that firms understate their transaction costs, artificially reducing the reported cost of investing which misleads customers.

#### ***Incorrect application of the PRIIPs methodology***

Some firms are incorrectly using the arrival price methodology when calculating transaction costs for primary issues. As a result, they are effectively crediting investment products with a negative transaction cost each time they subscribe to a new issue. They should instead be adjusting these to have no associated transaction cost, as per the European Securities and Markets Authority Q&A. We are concerned that this practice may decrease the perceived cost of investing through an artificially reduced transaction cost figure. In two instances, the correction of this error resulted in the transaction costs figure going from negative to positive.

#### ***Using the anti-dilution levy incorrectly***

This tool should only be used to reduce dilution. However, we identified instances where

its use is artificially reducing transaction costs at the expense of customers who subscribe into or redeem out of a product. In some cases, the levy applied is greater than the total explicit plus implicit trading costs. This more than offsets all transaction costs and results in an overall negative transaction cost figure.

### ***Ineffective oversight of outsourced arrangements***

Some asset managers opt to outsource the analysis and calculation of transaction costs, sometimes to overseas jurisdictions. Firms are required to take reasonable care to organise and control their affairs responsibly and effectively, whether these activities are undertaken in-house or outsourced. There are also specific requirements which apply to authorised fund managers who outsource certain activities. Failure by an outsourcer to adhere to rules or requirements remains the responsibility of the authorised firm. We identified a few instances where firms were failing to effectively oversee an outsourced activity for calculating transaction costs. During a transaction cost seminar, several firms advised that they used third parties to calculate their transaction cost and indicated in their evaluation forms that they would be investigating the results that they had been provided based on this evidence.

### ***Zero transaction costs***

Some UCITS which invest in other collective investment schemes disclose the charges for the trading of these underlying funds under their 'other ongoing costs'. They therefore do not disclose separate transaction costs. While this approach is consistent with existing guidance, it helps explain why some UCITS products are reporting a transaction cost figure of zero.

### ***High transaction costs***

Analysis of information received suggests that high transaction costs are justifiable and reflect firms' business models. Referring to these costs as high presumes that they are unduly so, but our findings displayed that it was usually the result of an aggressive trading strategy with high portfolio turnover.

## **Outcome of project**

We published a communication on 28th February 2019 setting out our concerns that the current errors being made by asset managers may reduce reported transaction costs and therefore, artificially reduce the perceived cost of investing. This may mislead consumers. Firms need to take steps to ensure they are applying the PRIIPs transaction cost methodology correctly. We are encouraging firms and individuals engaged in calculating transaction costs to review these findings and discuss them with us. Further action in this area could include more detailed investigations into specific firms, individuals or practices. Our findings have also been shared with EIOPA to inform their ongoing work in this area.

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