THE INVESTMENT ASSOCIATION

The Investment Association

PRIIPs Technical Discussion Paper 2015

draft response

17 August 2015

General comments

We recognise this TDP deals with specific technical issues and the first DP garnered views on the presentation of costs. We would like to remind the ESAs of our recommendations in response to the first DP, and in particular our response to question 26. We recommended that sufficient granularity is maintained within the summary indicators of costs to ensure the financially aware are not deprived of the information they need. Most notably, the possibility that the central measure of fund management charges – the ongoing charges figure – might be superseded in the name of cost and charge transparency appears counter-intuitive and without any clear justification in a competitive market. In practice, advisers, in particular, need enough information to advise their clients properly and this means more than a single figure.

Our recommendations would add just one more summary indicator to those currently used in the UCITS KIID; an indicator of transaction costs (or two in the case of products with significant structural borrowings). We believe strongly that this additional indicator should be developed separately and alongside the existing UCITS definition of ongoing charges. We note that the ESAs acknowledge the need to accommodate costs that cannot be accurately forecast (page 58 of the TDP) and to separate from fixed ongoing charges costs such as performance fees and transaction costs (page 53 of the TDP).

This is consistent with the draft MiFID II delegated act which describes transaction costs as additional to (ie. not a part of) the ongoing charges (recital 58). Where costs are estimated this recital requires an explanation that the estimations are based on assumptions and may deviate from actual costs. Therefore, it will be essential to MiFID that the KID summary indicators separate the predictable ongoing charges and volatile transaction costs and performance fees.

The PRIIP Regulation anticipates the evolution of online calculators of costs and it will be essential for these to work well that sufficiently granular data is readily available. The ESAs have an

opportunity now to define mandatory summary indicators according to how each type of cost behaves that will ensure PRIIP manufacturers all calculate the data the calculators will require.

Section 7 of the first DP suggested basing provisions for review and revision of the KID on the UCITS KII Regulation; an approach with which we agreed. A consequence of the UCITS requirements is that the UCITS KIID is revised if there is a material change to the ongoing charges figure. The KID's indicators of costs that are unpredictable, such as transaction costs, would cause very frequent revision if they are included in ongoing charges; we think a far more stable platform will emerge if transaction costs form a separate summary indicator, with a clear explanation that it is estimated using the average trading activity over the last three financial years (if that is the case). This would ensure the transaction cost indicator remains valid despite different trading activity and the ongoing charge would continue to be seen as a reliable indicator of future costs.

In the UK there are examples, which may signal a trend,towards taking fund charges in the form of a single all-inclusive fee from which the manager then reimburses the other parties involved in running the fund, such as the depositary, custodian and auditor. This all-inclusive fee is defined by reference to the UCITS definition of ongoing charges, so in the UK there may be serious commercial implications of broadening the definition to include other items. Moreover, a charges cap has been introduced for UK workplace pensions which requires all costs, including ongoing charges in underlying funds, to be capped. Transaction costs are not subject to the cap and are required to be reported separately. We note that the ESAs have drawn on the joint DWP/FCA Call for Evidence concerning this transaction cost reporting.

We are concerned that failing to disclose ongoing charges and transaction costs as separate indicators will mislead investors. Without transactions an investment strategy cannot be executed; an undue focus on transaction costs might contaminate the strategy and create undesirable incentives not to trade. If the investment decisions are good, higher transaction costs will deliver better net returns to the investor. However, ongoing charges will always erode those returns. This reality can be illustrated with an example of an active fund and a passive fund:

Active Fund has ongoing charges of 0.75% and transaction costs of 0.25%.
Passive Fund has ongoing charges of 0.5% and negligible transaction costs.

The active strategy outperforms the passive strategy by 0.4%. The question from an investor's perspective is which fund gave the better return. Were the ongoing charges and transaction costs combined into a single figure, then it would appear that the active strategy would have to deliver more than 0.5% outperformance in order to overcome the cost differential. In the example this would imply that Passive Fund did better by 0.1%. However, this approach misrepresents the reality.

In both cases the performance is determined by the investments held. If different transactions had occurred, then the investments and the transaction costs would be different; therefore the outperformance would have been different. The transaction costs are an integral part of the strategy and cannot be separated. Therefore the true cost differential is 0.25% and Active Fund did better by 0.15%.

The reasoning behind this explanation may be too complex for many retail investors to understand. But the conclusion it draws is something they should be informed about. And so, it is essential advisers – and others in the wider market, such as providers of online tools - using the KID can explain to their clients the reality of how costs behave. For this they need the sufficient granularity that we have consistently supported– and not a single aggregated number alone.

2. Risk and Rewards

2.2 Common issues for both the risk indicator and performance scenarios

Question 1:

Please state your preference on the general approach how a distribution of returns should be established for the risk indicator and performance scenarios´ purposes. Include your considerations and caveats.

We prefer option (a), distribution of returns obtained from historic data. At the time of the development of the UCITS KIID, independent academic research showed that past volatility was as good a guide to future performance as any other more complicated (and costly) metric. Given that presentation of the risk indicator will be at a generalised level (eg. across a range of 1 to 7), we urge the Joint Committee not to over-engineer the risk calculation methodology, as this would add cost, which may be passed on to consumers, without any correlated benefit.

Question 2:

How should the regulatory technical standards define a model and the method of choosing the model parameters for the purposes of calculating a risk measure and determining performance under a variety of scenarios?
What should be the criteria used to specify the model?
Should the model be prescribed or left to the discretion of the manufacturer?
What should be the criteria used to specify the parameters?
Should the parameters be left to the discretion of the manufacturer, specified to be in accordance with historical or current market values or set by a supervisory authority?

As stated above, we prefer option (a). If however the Joint Committee rejects option (a) and opts for a simulation, our view is that flexibility should be allowed for the manufacturer to choose the model it considers most appropriate to the aim of providing clear pre-trade information for investors. This flexibility would allow firms to use the model most relevant to the characteristics of the product concerned, which should go furthest in reducing the asymmetry in understanding between the manufacturer and the consumer, as intended by the co-legislator.

We do however recommend that rules to select the input variables should be standardised and consistent across all models. Supervisory authorities should therefore prescribe the relevant input

parameters. As indicated in the Discussion Paper, we would recommend a confidence level no higher than 95%, to avoid undue focus on tail risk.

2.2.3 Time value of money – what represents a loss for the retail investor?

Question 3:

Please state your view on what benchmark should be used and why. Are there specific products or underlying investments for which a specific growth rate would be more or less applicable?

We consider option (a), the amount invested without any adjustment, to be the option most likely to create a fair and level playing field, and to aid comparability across different PRIIP types.

While the time value of money is an important concept when investing in any type of product (and even more important for investments with recommended long holding periods), we believe the other options - to use either a risk-free rate or a rate of inflation - are unfeasible in the absence of a common understanding of how those rates are best calculated. If such an approach were followed by the Joint Committee, the calculation of such rates would need to be centralised and prescribed by the supervisory authorities. Letting manufacturers decide on the growth rates to be used would result in widely varying projected performance figures among not only different PRIIP types, but also between similar PRIIPs from different manufacturers, and could undermine any concept of comparability.

Because reliance on an unadjusted growth rate could, however, be misleading over the longer term, the benchmark could be supplemented with a narrative explanation of the longer term effect of inflation, particularly for products with a longer recommended holding period.

Question 4:

What would be the most reasonable approach to specify the growth rates? Would any of these approaches not work for a specific type of product or underlying investment?

With respect to the specification of asset growth rates, the most reasonable approach would be to use risk premiums prescribed by supervisory authorities, based on historical returns of each asset class and asset type. As the risk premiums may change over time, regular evaluation by such authorities would be necessary.

2.2.4 Timeframe of the risk and reward information

2.2.4.1 ***Reflection of time frame in the risk indicator***

Question 5:

Please state your view on what time frame or frames should the Risk Indicator and Performance Scenarios be based

As the KID includes a reference to a recommended holding period, we believe that it would be appropriate to build the risk indicator and performance scenarios so that they reflect the recommended holding period stated by the manufacturer, including narrative information about the limitations of the indicator, eg. that the risk level and performance scenarios are likely to be less relevant if the product is not kept for the recommended holding period. Any default holding period should be five years, as in the UCITS KIID.

2.3 Construction of a Risk Indicator

Incorporating market risk into the Risk Indicator

Credit risk 2.3.1.2

Importance of credit risk

High level description of possible credit risk measures

Question 6:

Do you have any views on these considerations on the assessment of credit risk, and in particular regarding the use of credit ratings?

When reviewing credit risk, it is important to distinguish between the credit risk of the PRIIP and the credit risk of underlying investments of the PRIIP, which would typically be subsumed into the consideration of market risk.

Where the PRIIP is a product such as an insurance product or a bank sponsored balance-sheet product, we agree that, depending on the creditworthiness of the counterparty, credit risk is a key risk that consumers should be aware of. In this case, the credit risk of the PRIIP should be incorporated as a separate item in the indication of risk, rather than amalgamated with market risk.

In terms of determining credit risk, we recommend using average third party credit ratings rather than credit spreads. We agree that these quantitative credit risk measures may need to be complemented with additional qualitative measures of credit risk. For manufacturers or obligors for which credit ratings or the other mitigating factors are not available, then credit risk could be assessed on the basis of an analysis of credit ratings of comparable obligors.

In addition, to enable meaningful comparisons between different types of PRIIPs, it is essential to enable off-balance sheet products, such as AIFs, to highlight that they provide no or little credit risk, as the investor is not exposed to either the product provider or any other single obligor and the assets are held in a separate ring-fenced account with the AIF's depositary, and protected from default by the manufacturer.

Liquidity risk

2.3.1.3 *Liquidity risk*

Question 7:

Do you agree that liquidity issues should be reflected in the risk section, in addition to clarifications provided in other section of the KID?

We agree that liquidity risk should be reflected in the KID and that a distinction needs to be made between liquidity risk and the liquidity profile of a product.

As liquidity risk is difficult to quantify, and will vary according to market conditions, fund size, and investor profile, we do not believe that it should be displayed quantitatively in the risk section. Rather, we recommend providing a qualitative narrative description.

The liquidity risk of a product should be presented in the KID´s risk section, as part of the summary indicator, but as a separate narrative or warning.

Question 8:

Do you consider that qualitative measures such as the ones proposed are appropriate or that they need to be supplemented with some quantitative measure to some extent?

Should cost and exit penalties for early redemptions be considered a component of the liquidity risk and hence, be used to define a product as liquid or not for the KID purpose?

We do not believe it is possible to present a meaningful quantitative indicator for liquidity risk, and recommend using a narrative approach, as described above.

2.3.2 Translation of risk measures into risk indicators

Option 1

Qualitatively based indicator combining credit and market risk, complemented by a quantitative market risk measure

Question 9:

Please state your views on the most appropriate criteria and risk levels´ definition in case this approach was selected.

We believe that market, credit and liquidity risk should be shown as separate indicators. We believe that aggregating risks with very different characteristics would be a very subjective exercise and provide little or no benefit to investors, but could mislead them.

Market credit risk and product credit risk should be measured separately.

Liquidity risk should not be combined with the other risk measures to define the overall risk level, but should be explained in a narrative alongside the indicator/indicators.

Option 2

Indicator separating assessment of market risk - quantitative measure based on volatility - and credit risk - qualitative measure, external credit ratings

Question 10:

Please state your views on the required parameters and possible amendments to this indicator.

Option 2 is the best available option because it is the only option assessing market and credit risk separately, which is of great importance for distinguishing between different types of PRIIP and to help investors understand whether the PRIIP itself is subject to the creditworthiness of its manufacturer. Also, Option 2 is the closest approximation to the existing UCITS SRRI, which has been consumer tested and implemented in the UCITS KIID.

Option 3

Indicator based on quantitative market and credit risk measures calculated using forward looking simulation models

Question 11:

Please state your views on the appropriate details to regulate this approach, should it be selected.

We prefer option 2. If option 3 were to be selected, we recommend the second alternative, a long term risk measure over the recommended holding period, using simulated pay-outs at maturity for structured products. For classical market funds, option 3 should produce very similar results to option 2, while option 2 would be much easier to implement, particularly for smaller product providers.

Question 12:

Please state your views on the general principles of this approach, should it be selected. How would you like to see the risk measure and parameters, why?

We prefer option 2. Regulators could prescribe just the methodology to determine parameters. For example, for volatility, the requirement could be that the value of this parameter is the effective weekly volatility observed over the past five years.

Regarding the proposed "extensions" of this approach, these would further increase the costs of implementation in an unjustifiable way considering that the end game is presentation of the risk indicator at a fairly generalised level.

Question 13:

Please state your views on the potential use of a two-level indicator. What kind of differentiators should be set both for the first level and the second level of such an indicator?

A two-level indicator would probably be too difficult for consumers to understand. Additional information can be signposted for those consumers who wish to consider it.

2.3.3.2 Scale of the Risk Indicator

Question 14:

Do you have suggestions or concrete proposals on which risk scale to use and where or how the cut-off points should be determined?

We believe the definition of the scale of the risk indicator should remain consistent with UCITS approach, which uses a scale of 1 – 7. Using a narrower scale would not allow sufficient differentiation between various types of products.

2.4 Performance scenarios

Question 15:

Please express your views on the assessment described above and the relative relevance of the different criteria that may be considered.

We believe that past performance remains the most reliable indicator on the basis of validated and confirmed figures that accurately disclose how the product has behaved under specific conditions and should therefore be used as a basis for performance scenarios. Independent academic research when the UCITS KIID was being developed indicated that past volatility was as good a measure as any other.

If a probabilistic modelling approach were chosen, we would support the use of three scenarios: expected, upside and downside. These should be accompanied by narratives explaining the meaning of the information provided.

2.4.4 How to construct performance scenarios: methodological details to be prescribed in the regulation and input required

2.4.4.1 Definition and number of scenarios

What–if: manufacturer choice

Question 16:

Do you think that these principles are sufficient to avoid the risks of manufacturers presenting a non-realistic performance picture of the product? Do you think that they should be reinforced?

We would expect any failure by manufacturers in this regard to be addressed as supervision/ enforcement issues by national regulators.

What- if: prescribed approach

Question 17:

Do you think the options presented would represent appropriate performance scenarios? What other standardized scenarios may be fixed?

If a what-if approach were chosen, an historical scenario (option a) over the recommended holding period is the preferred solution, if possible extended over multiple periods in the past. Setting a predefined growth rate/performance of the underlying investments would not in our view be feasible, as growth rates would have to be defined for an impossibly large number of instruments.

Probability approach

Question 18:

Which percentiles do you think should be set?

We support the three scenarios suggested: a pessimistic scenario as the 10th percentile of the distribution, a neutral scenario as the 50th percentile, and an optimistic scenario as the 90th percentile.

Combined approach

Question 19:

Do you have any views on possible combinations?

We believe that combination scenarios will be too complex for the average PRIIP consumer to understand.

2.4.4.2 Other methodological issues to calculate performance in each scenario

Inclusion of credit risk events in the scenarios

Question 20:

Do you think that credit events should be considered in the performance scenarios?

We are not in favour of including credit events in performance scenarios. If this is a significant risk to the investor, this should be brought out in separate disclosure, such as issuer risk for a balance sheet product or guarantor risk for a guaranteed product.

Question 21:

Do you think that such redemption events should be considered in the performance scenarios?

Performance scenarios should show the impact of early redemption of PRIIPs with a fixed holding period.

Investment horizon of the scenarios

Question 22:

Do you think that performance in the case of exit before the recommended holding period should be shown? Do you think that fair value should be the figure shown in the case of structured products, other bonds or AIFs? Do you see any other methodological issues in computing performance in several holding periods?

From a fund perspective, the scenarios envisaged do not appear to be applicable to open-ended funds such as many retail AIFs, which allow for regular ongoing redemption, or closed-end retail funds (such as listed investment companies) where investors typically dispose of their interests on the secondary market.

3 Costs

3.1 Identifying the costs

3.1.1 Funds

3.1.1.1 List of costs to be taken into account

Entry-Exit costs

Question 23:

Are the two types of entry costs listed here clear enough?

Should the list be further detailed or completed (notably in the case of acquisition costs)?

Should some of these costs included in the on-going charges?

We think the nature of the cost is the key to determining what is an entry or exit cost. It is the one-off nature of costs that represent the difference between the initial amount an investor pays and the amount that is applied to buying units, or is otherwise exposed to the risks and rewards of a PRIIP, which should define the entry charge. Similarly, exit costs are the difference between the results of exposure to the PRIIP and the amount actually paid to the investor at the end of the investment.

Exit costs should be added to the list.

Ongoing charges should include only costs that are deducted from the value of the PRIIP so it should not include entry and exit costs.

On-going charges

Question 24:

How should the list be completed?

Do you think this list should explicitly mention carried interest in the case of private equity funds?

The list in (a) would be clearer and would reflect the broader array of legal and governance structures available to AIFs if the first two bullets were replaced with:

- the manager of the fund
- the directors of the fund
- the general partners of the fund

…

We do think carried interest should be included but it is a form of performance fee so should be dealt with under item (h).

Question 25:

Should these fees be further specified?

The inclusion of property management services needs to be carefully defined because there are a number of costs arising under this heading that are more like transaction costs in nature, for example, development, maintenance and lease renewal and negotiation costs.

Question 26:

Should these fees be further specified?

We suggest listing fees should be added in order to recognise some types of AIF are exchange-traded.

Question 27:

Should these fees be further specified? The "recovering fees" cover the following situation: when an investor receives income from foreign investments, the third-country government may heavily tax it. Investors may be entitled to reclaim the difference but they will still lose money in the recovering process (fee to be paid).

We do not think caption (d) is required. To the extent that the recovering fees are paid by the fund they are already required to be included under captions (a), (b) or (f).

Question 28:

This list is taken from the CESR guidelines on cost disclosure for UCITS. What is missing in the case of retail AIFs (real estate funds, private equity funds)?

In the case of private equity funds, would it be relevant to include a breakdown of flows, distinguishing those ("out") paid by the fund for the proper functioning of its financial portfolio management from those ("in") paid by the target company for the provision of advisory services. This breakdown would allow to clarify real costs for investors (instead of only indicating the net amount), knowing that "in" will be deducted from "out").

In the case of costs of distribution, would this need to be detailed depending on the type of costs of distribution?

To what extent are these costs different from the distribution fees mentioned in the Entry costs above?

This question is the most general question about the list (a) to (t) in the TDP and so we have used it to make comments about items in the list where no specific question is asked before going on to answer the detailed questions asked.

We agree with using the CESR guidelines as the basis for developing a list of costs to be taken into account. We think the approach of defining the main parties to which fees are paid is robust and mitigates the risk of aggressive interpretations of particular cost items. However, in some instances we would prefer to see reference to the KII Regulation as the basis for the KID formulation instead of the CESR guidelines.

Captions (h) to (m)

Captions (h) to (m) are a list of items that were regarded as valid exclusions from the ongoing charges of a UCITS in order to communicate the cost of UCITS to consumers in the most meaningful way. We think it would be most helpful to consumers if the KID carried a summary indicator of ongoing charges that is consistent with the well-established ongoing charges figure in the KIID. The items listed in (h) to (m) should be disclosed in the KID, but not by loading them into the ongoing charges figure. We discussed this further in our response to question 26 of the first DP and in our general comments at the beginning of this response.

Caption (n)

Caption (n) refers to investing a "substantial proportion" in underlying funds as the trigger to bring into accounts the costs incurred in the underlying funds. This reference has caused a divergence of views amongst Member States as to what constitutes "substantial." Figures of anything from 10% to 30% have been used and even 50% suggested. We think this misses the point; what matters is both the proportion and the level of charges in the underlying fund. Clearly, in terms of a material contribution to the overall level of costs, a much larger holding in an underlying fund with very low charges is possible compared to an underlying fund with higher charges. Therefore we think the wording in captions (o) and (p), which make no reference to the size of the holding are more appropriate and the term "substantial proportion" should be removed. In the broader context the costs of underlying funds will then be brought into account whenever their contribution is material.

Caption (r)

We believe that caption (r) misrepresents the nature of the arrangements being discussed. It is not correct to regard a lending agent's share of stock lending income as a cost to the fund. Lending income is normally shared between the fund and the lender in a pre-agreed ratio, for example, 60:40 in favour of the fund. It is essential that these arrangements are transparent and that the agreed ratio is fair. But to report in isolation a "cost" of €40 misrepresents that fact that the lending activity is generating a net benefit to the fund of €60. If the lender's share of the fee were to be regarded as a cost then, aside from renegotiating the agreed ratio, the only way to reduce the "cost" would be to

lend less. Whilst it would be tempting to regard halving the €40 as providing a cost saving of €20 to the fund, the reality is that the fund would be €30 worse off due to lost revenue. Setting aside any philosophical debate about whether the investment strategy should permit stock lending, regarding the lender's share of the revenue as if it was a cost creates a perverse incentive not to lend and denies the fund the benefit of this revenue stream.

The purpose of the fee sharing provisions in caption (q) is to guard against manipulation of the ongoing charges figure by shifting costs. The point with stock-lending operated by a custodian is that the custodian keeps a share of the revenue in order to subsidise the custody fee. This would reduce the disclosed ongoing charge figure, so the custodian's share of the lending revenue should be brought into account for the ongoing charges figure. However, where a lending agent is used, the circumstances in caption (q) do not arise; the lending agent's share of the revenue is not subsidising costs that would otherwise be included in the ongoing charges figure. The effect of caption (r) is to misrepresent the benefit of stock lending to the fund.

Captions (a) to (g)

Subject to our concerns expressed in our answer to question 25 regarding the nature of some property-related costs, we think the list is complete in respect of real estate funds.

We do not have a view on breaking down the flows for private equity funds.

We note that the PRIIP Regulation reflects that in some Member States, such as the UK, investors pay distributors directly. Consequently these costs are not known by the fund or its manager. The KID will be required to warn these investors that these costs are not disclosed in the KID and will be provided separately by the distributor. We think the caption (g) should be modified to more narrowly reflect that distribution costs should be included only to the extent they are paid by the fund. This is consistent with the overarching principle on page 53 that the disclosures relate to types of cost borne by the fund and reflects that the KID is a product disclosure document.

These costs differ from distribution fees described as entry costs in the way they are charged but they may end up being paid to the same party.

Question 29:

Which are the specific issues in relation to this type of costs?

Interest on borrowing is a specific exclusion from the UCITS ongoing charge and should not be combined in into the equivalent PRIIP figure. Where material, a separate summary indicator should be shown for financing costs.

Most retail funds are only able to borrow modest amounts on a short-term basis to fund cash flow requirements associated their investment activities. Interest incurred on such borrowing is, by its nature, an offset to investment returns. An alternative approach to short-term borrowing would be for the manager to agree special settlement arrangements in respect of an investment. This would adversely affect the transaction price but would eliminate any interest charge. There is a risk that inflating the ongoing charges figure with interest costs potentially creates an incentive to avoid interest even though the alternative may have a greater adverse effect on investors' value.

International accounting standards (IAS 1.82) define profit and loss within the primary income statement as comprising just three key components: revenue, finance costs and tax expense. Revenue is then analysed further to reveal its income and expense components in the supporting notes. The point is that finance costs are regarded as fundamentally different to expenses because they relate to the capital raising rather than the delivery of the investment strategy. Therefore they should be disclosed as a separate summary indicator in the KID.

In most retail funds interest incurred will be immaterial. However, we recommend that funds that can borrow on a long-term basis should have a separate summary indicator in relation to finance costs. The effect of borrowing is to magnify the risks and rewards that might arise from the investment strategy and it would be informative to isolate the costs of creating this effect

Question 30:

Is it relevant to include this type of costs in the costs to be disclosed in the on-going charges?

Which are the specific issues in relation to this type of costs?

Which definition of Costs for capital guarantee or capital protection would you suggest? (Contribution for deposit insurance or cost of external guarantor?)

We have not answered this question.

Question 31:

Which are the specific issues in relation to this type of costs?

Should the scope of these costs be narrowed to administrative costs in connection with investments in derivative instruments?

In that respect, it could be argued that margin calls itself should not be considered as costs. The possible rationale behind this reasoning would be that margin calls may result in missed revenues, since no return is realized on the cash amount that is deposited, and that:

i) No actual amount is paid to a third party. Hence, one could argue whether these should be defined as costs of investing from a fundamental point of view.

ii) It would be very challenging to quantify the actual missed revenue amount. Assumptions would be needed on the rate of return that would be realized on the deposited cash amount. Daily fluctuations in margin account balances will add to the complexity of required calculations.

Payments related to holding derivatives are specifically excluded from the UCITS ongoing charge and should not be combined in the equivalent PRIIP figure. These payments relate to making margin calls or pledging collateral. However, the money deposited in a margin account or assets pledged remain the property of the fund; they are simply held in a different account by a central counterparty as security to ensure the fund can meet potential investment losses.

The fund may or may not earn interest on balances deposited as margin but, if they do not, it is not appropriate to describe the interest forgone as an opportunity cost that should be brought into account. In concept the position is no different to the cash expended on buying stocks and shares; it would not be appropriate to suggest that interest forgone on the cash used to buy shares is a cost to the fund.

Question 32:

Which are the specific issues in relation to this type of costs?

Should this type of costs be further detailed/ defined?

We recognise this question as dealing with payments for investment research. You will be aware that the MiFID II delegated acts are tackling the question of unbundling research payments from broker commissions. It is unclear whether the conclusions reached will be extended the UCITS and AIFM directives on a harmonised basis or implemented by Member States on a unilateral basis. Nevertheless it is these conclusions that will determine whether research payments are transaction costs, and so dealt with under caption (k), or are other costs that should form part of the ongoing charges figure.

In our view, the effect of caption (m) is to bring into account the research element paid for using broker commissions. This would appear to double count this item in both captions (k) and (m). In our view caption (m) should be deleted and a new bullet added under caption (b) to cover "providers of investment research, other in exchange for placing of dealing orders." Therefore, whatever the outcome of MiFID II in this respect and its extension to fund regimes, research payments will be included either in caption (k) or in caption (b).

Question 33:

How to deal with the uncertainty if, how and when the dividend will be paid out to the investors?

Do you agree that dividends can be measured ex-post and estimated ex-ante and that estimation of future dividends for main indices are normally available?

In the context of funds, dividends are received by the fund because the fund is the legal owner of the shares. Initially the dividend adds to the value of the fund units so each investor benefits from the dividend through the price of their units. Whether or not there is a subsequent dividend pay-out to investors, there is no uncertainty that investors will receive the value of the dividend.

We do not agree that structured product providers should be able to benefit from dividends in the structured note scenario described in caption (t). Where the pay-off is described as the performance of a basket of shares, it is reasonable to expect the performance to include both income and capital gains. If the issuer of the structured note offers a pay-off linked only to capital gains, and keeps the income, investors should be made aware that the performance of the basket of shares is being shared between the investor and the product provider. In this scenario, the product provider is earning revenue from managing their clients' money.

3.1.1.2 Specific issues related to certain types of costs

1. Transaction costs (caption (k))

Identification and suggested calculation methods of the different components of transaction costs

Question 34:

Is this description comprehensive?

We note that the description is a re-articulation of caption (k) which is itself taken from the list of items excluded from the ongoing charges figure in the CESR guidelines. In this respect we think it was developed as a valid list of items to be excluded from ongoing charges but was not validated as a list of transaction costs. Therefore we think each item in the list needs to be validated and this should be done against the MiFID II criterion of whether or not the item is not caused by the occurrence of underlying market risk. We give our views on this basis in our answers to the questions in this section of the TDP. This will ensure the KID delivers the necessary summary indicators in order to allow investment firms to perform the aggregation of costs required by MiFID II.

We note a second paragraph has been added to caption (k) which is taken from the CESR guidelines where it defines an override. In the CESR guidelines the effect of the override is to state that transaction costs should be excluded but that any transaction costs paid to specified parties should be included. This override is not required here because transaction costs are included regardless of who they are paid to.

We do not think the list is a comprehensive list of transaction costs. The detailed definition used in international accounting standards is more comprehensive: "Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs." (IFRS 9 B5.4.8). Real Estate Funds, for example, incur a more extensive list of transaction costs such as agents' fees, legal fees valuation fees, letting fees and lease renewal fees.

The list also includes items that we do not believe should be included as costs. In our answer to question 39 we explain why market impact is caused by the behaviour of the market and how

including market impact as if it were a cost creates undesirable incentives for traders to act in a way that may not be in the clients' best interests. We would agree that there are transaction costs implicit within bid-ask spreads but not that the entire bid-ask spread is an implicit cost. As identified by the ESAs on page 26 of the TDP some of the spread is a measure of liquidity and in our answer to question 38 we discuss the trade-off between liquidity and market risk. In our answer to question 40 we highlight why, in the case of funds of funds, it may be a level of complexity too far to attempt to include as transaction costs the charges build into the pricing mechanisms of the underlying funds in order to protect investors in those underlying funds from dilution.

Question 35:

Can you identify any difficulties with calculating and presenting explicit broker commissions?

How can explicit broker commissions best be calculated ex-ante?

We do not anticipate difficulties calculating explicit broker commissions. There are a number of options for calculating broker commissions on an ex-ante basis. This could be based on an appropriately blended average of the commission rates most recently agreed with brokers or based on the actual rates apparent from commissions paid. We do not think it will be appropriate to present broker commissions separately to other transaction costs, and we discuss presentation issues in detail in our answer to question 41.

Questions 36:

How can the total of costs related to transaction taxes best be calculated?

How should this be done to give the best estimate ex-ante?

Are there other explicit costs relating to transactions that should be identified?

Do you think that ticket fees (booking fees paid to custody banks that are billed separately from the annual custodian fee paid for depositing the securities) should be added to this list?

We think the best approach to calculating transaction taxes (such as stamp duty and FTT) on an ex-ante basis is a weighted average of the transaction tax rates applicable in each country in which the portfolio is invested at the end of the financial year. An alternative approach might be to use the actual rates apparent from transaction taxes paid, but geographical shifts in the portfolio over the year make this approach less likely to represent the future shape of the portfolio.

Unlike other transaction costs transaction taxes may be asymmetrical. For example, in the UK, stamp duty is applied to purchases but not to sales. Therefore shifting a portfolio from US to UK equities would incur very different costs to shifting from UK to US equities.

It is perverse to include transaction taxes in costs disclosures because the only way of managing such costs would be to trade less given that fund managers cannot negotiate lower transaction tax rates with governments. Therefore there is a risk that this disclosure will create a fiscal incentive not to trade when trading might be in clients' best interests. In the absence of a clear link between transaction costs and performance it also creates an inequality by making active management appear to be more expensive than passive management simply because the active manager seeks to add value by trading in countries with transaction taxes.

We think non-recoverable withholding taxes on dividends (WHT) should be identified. In the UK the DWP/FCA have identified such taxes as transaction costs. Transaction costs and WHT are both taxes on investing and it would be unfair to include one type of tax on investing and exclude another.

Some types of PRIIP are less tax efficient and incur tax charges within the PRIIP that cannot be recovered by, or on behalf of, the investor. Where the PRIIP itself incurs a tax charge, this should be included in the disclosure of costs (although perhaps not as a transaction cost).

We do not think ticket fees should be added to the list because they are already included in paragraph (a) on page 54 of the TDP. This requires all payments made to custodians to be included in the amount disclosed as ongoing charges, regardless of the basis on which they are calculated.

Question 37:

As regards the above mentioned estimate, can the fair value approach be used?

It is not clear how the fair value approach could be used to estimate the commission-equivalent element in the spread. We understand fair value in the accounting context to be the price that would be received to sell an asset (ie. the bid price) and the transaction price is the price paid to buy an

asset (ie. the ask price). An estimate of spread for a particular asset could be made by deducting the fair value from the transaction price provided that the fair value is determined on a bid basis at a time reasonably close to the time of the trade (for example, at the next market close or at the next calculation of a fund's net asset value). However, this approach does not facilitate an estimation of the commission-equivalent element of the spread.

In relation to this question we do not agree with the assertion made in footnote 23 which suggests that dealers should know the spread of a security in order to fulfil their best execution obligations. According to MiFID II, best execution is about ensuring dealers secure "the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order." If the objective is to purchase a bond, best execution is about ensuring it is done at the lowest possible ask price within a reasonable timeframe. The lowest ask price could be associated with a wider spread than the spread on a higher ask price. The bid price at the time, and hence the spread, is irrelevant.

Question 38:

Can you identify any other difficulties with calculating and presenting the bid-ask spread?

Do you believe broker commissions included in the spread should be disclosed?

If so, which of the above mentioned approaches do you think would be more suitable for ex-ante calculations or are there alternative methods not explored above?

Measuring and (more importantly) decomposing the bid-ask spread creates a variety of challenges. We have commented in previous papers that this is one of the most difficult disclosure areas, not just technically but fundamentally and conceptually.[1]

The Investment Association takes the view that the bid-offer spread provides a useful indication of the overall economic experience of monies invested. In other words, by giving investors estimates of bid-offer spread, together with information on product charges and on explicit costs (brokerage and taxes), a more complete picture can be provided of the friction that must be overcome in generating an investment return.

[1] Our most recent paper can be found here: http://www.theinvestmentassociation.org/assets/files/consultations/2015/20150210-iacostsandchargesreport.pdf

That does of course still raise the question of whether there is properly speaking any commission included in the spread that can or should be isolated for the purposes of making better disclosure to investors as to the true economic cost of ownership. Simply put, we are sceptical and are unclear as to the objective of such an approach.

We note that the two considerations in the analysis of bid-ask spreads on pages 60 to 62 are confusing. The first consideration is about calculating the precise spread cost at any point in time and the second is about how to disclose the different elements of the spread. If the goal of regulators is to identify payment streams (rather than communicate the overall economic experience of market costs), then this can only truly be done where the broker is actually charging a commission.

In practice of course, a market maker in fixed income or other asset classes takes the position off the customer at an agreed price and, in so doing, takes on all the risk of closing out that position at a loss to the market maker. Individual traders employed at the market maker are incentivised to close out at a profit, of course, but the customer is no longer 'on risk' and the trader at the market-maker will only earn money from the transaction only to the extent that she can quote a competitive price and also close out the position. The 'commission', in other words, could evaporate and cannot be said to be 'included' in the spread but to be contingent on the spread actually being crystallised by offloading the position. (Of course, in some circumstances, price moves might mean the market maker fails to crystallise any of the bid-offer spread, though that is arguably a rather less likely scenario. We also ignore, for these purposes, any possibility of abusive behaviour, such as collusion between market makers, since that is in principle dealt with elsewhere in the legislation.)

While we remain sceptical about the practicalities, we recognise that others in the debate are exploring whether, with sufficient data, the amount equivalent to a broker's commission within a spread, could be conceptualised and identified for the purpose of disclosure to clients. The logic behind this is that the overall bid-offer spread is a separate matter, being a function of the liquidity of a stock (ie, the capacity of the market as a whole to absorb orders without disturbing the price). The specific market price of a stock fluctuates, of course, according to supply and demand in the market; but the size of the bid-offer spread is influenced by the stock's liquidity. (In the extreme, if there is no one else willing to buy an asset that you have acquired, and you want to sell it without delay, it is worthless, however much you paid for it.)

In order to be consistent with the requirements of MiFID II, it could be argued that the spread should be excluded from the costs disclosed in the KID because it is a function of the liquidity in the market for that asset.

This approach is also consistent with international accounting standards (IAS) in which the definition of transaction costs does not include the bid-ask spread (IFRS 9 B5.4.8). Moreover, IAS requires

that, when an asset is purchased, the difference between the transaction price (which is the actual ask price for the transaction) and the fair value (which is the bid price of the asset purchased) is recognised as a gain or loss (IFRS 9 B5.1.2A). In other words the difference between the ask price and the bid price will be recorded (albeit artificially) in the profit and loss account as a loss on the investment. In any event, significant estimation will be needed.

For the reasons discussed in our answer to question 41 we continue to prefer a standardised approach where indicative figures are provided in a centralised table. This is similar to option iii on page 61 of the TDP but we do not agree with the use of a proportion (for example 50%) of the spread being designated as equivalent to a broker's commission for the following reasons.

Equity markets are structured differently to bond and other OTC markets. They have in common a dealer that stands ready to trade on their own account in order to provide liquidity to the market. However, equity markets differ in that trades are intermediated by brokers that do not trade on their own account. Dealers "make a market" by putting at risk their own capital and in return they aim to make a frequent but marginal profit by selling stocks at a higher price than they bought them at. The difference in these buying and selling prices is the bid-ask spread and the size of this spread is determined by the dealer as a function of the liquidity of the stock in question. Therefore, if liquidity declines the dealer widens the spread and vice versa. Brokers attempt to match buyers and sellers or else fulfil orders by trading with the market maker, but do not put at risk their own capital. For their services they earn a fee, usually negotiated in advance, expressed in terms of a number of basis points of the value traded. This fee is largely unrelated to the liquidity of the stock in question.

Suppose, for example, the spread on an equity is 25 basis points and a fund has agreed a commission rate of 15 basis points with a broker. If liquidity in the stock becomes scarce the spread widens, say it doubles to 50 basis points. The broker's commission remains constant at 15 basis points. If the stock was a bond with a spread of 50 basis points and 50% was estimated to be equivalent to the broker's commission, a doubling of the spread to 100 basis points would suggest that the commission-equivalent portion had increased from 25 to 50 basis points. This is inconsistent with the equity commission that the approach is attempting to replicate. We suggest that the ESAs develop a central table of commission-equivalent rates. One way to do this might be to observe typical spreads for trading highly liquid bonds in normal market conditions and assuming these carry only a negligible liquidity premium.

Of the other options on page 61 of the TDP we consider option i to be inappropriate because the KID is intended to require disclosures – not to restructure the way the market operates. It is also likely to be impractical especially in respect of third-country markets which might simply refuse to provide gross pricing. We think option ii will require considerable cost for competent authorities to build the

supervision mechanisms that would be necessary to ensure realistic estimates are used. Such costs might be difficult to justify because, as observed on page 66 of the TDP, the approach would create disclosure information that has a spurious level of accuracy.

Question 39:

Do you believe that market impact costs should be part of the costs presented under the PRIIPs regulation?

If so, how can the market impact costs best be calculated?

How should this be done to give the best estimate ex-ante?

No, market impact should not be presented as a cost of a PRIIP because it is caused by the occurrence of underlying market risk. This is the criterion used by MiFID II to define the perimeter of the costs and charges that should be disclosed. We are not convinced by the analysis of market impact in the TDP.

Market impact is a measure of the market movement due to information leakage. It is a measure of the impact on the market price of presenting information to the market about trading interest. Knowledge of unfilled trading interest is a valuable commodity and information revealing increased demand allows other market participants to infer a trader's market intelligence. Therefore, when a trader presents a large order to the market, the market responds by moving against the trader. This movement is market impact and, as it is a change in market price in response to a shift in the balance of market-wide supply and demand, it is a result of underlying market risk.

Part of the analysis on page 66 of the TDP notes that costs such as market impact might, by chance, sometimes be negative such as when a small seller trades while there is a large buyer in the market. The fact that market impact arises as a feature of the condition of the market rather than the trade demonstrates that market impact is a result of underlying market risk.

Market impact can be mitigated by carefully working an order in the market. Breaking up an order into smaller tranches and placing them with a number of brokers makes the order fragmented and less informative. However, this delays the completion of the order and may result in failure to fill the entire order. Delay costs (the market moves against the unfilled position) and missed trade opportunity costs (the intended transaction is only partially completed) are the price of reducing

market impact. A trader's skill in balancing the interactions between market impact, delay costs and missed trade opportunity costs will contribute significantly to the value of a clients' investments.

Contrary to the conclusion expressed on page 63 of the TDP, it is the disclosure of market impact as a transaction cost that would incentivise traders break up orders and to accept disproportionate delay costs and missed trade opportunity costs in order to minimise market impact. In reality traders should be free to balance the costs of transacting against the costs of not transacting in the best interests of their clients and should not be constrained by the disproportionate emphasis caused by disclosing only half the equation.

Question 40:

How should entry- and exit charges be calculated considering the different ways of charging these charges?

How should this be done to give the best estimate ex-ante?

Can you identify any other problems related to calculating and presenting entry- and exit fees?

These charges are impossible to predict. One approach would be to assume there will be no inflows or outflows in the underlying funds held by the fund of funds. Although this probably will not be the case, it is impossible to know whether the fund will experience net inflows or net outflows, let alone quantify those flows. Therefore it is not an unreasonable assumption and, if accepted, it means there will be no entry or exit charges in the ex-ante disclosure.

The purpose of these entry and exit charges are to protect the underlying funds' existing investors from the dilutive effects of other investors entering or exiting the fund. If the ex-ante disclosure were to include the entry and exit charges built into the pricing mechanism then, in principle, there should be an offset for the positive effect of other investors in the underlying funds paying entry and exit charges.

Moreover, if the methodology for calculating transaction costs suggest on page 67 of the TDP is used, the effect of the lack of predictability of the portfolio turnover rate (we discuss this further in our answer to question 41) is likely to be far more significant than the spurious accuracy achieved by attempting to take account of entry and exit charges within the underlying funds pricing mechanisms.

Suggested Methodology for a calculation of the overall transaction costs

Question 41:

Which other technical specifications would you suggest adding to the above mentioned methodology?

Which other technical issues do you identify as regards the implementation of the methodology?

We agree with the approach to estimating transaction costs by multiplying a portfolio turnover rate (PTR) by average transaction costs. We recommend using an average taken over three years for the PTR figure.

In respect of the PTR we would recommend a different definition to that given on page 67 of the TDP. In our February 2015 position paper on meaningful disclosure of costs and charges (attached to this response) we provide an analysis of three different methods for calculating PTR. We used actual data from ten funds to demonstrate that they all give reasonably similar results and all demonstrate the volatility of trading activity from one year to the next. For practical reasons we recommended an approach based on the US SEC methodology. However, if the definition in the TDP is used we recommend that it should be divided by two before being used in the calculation of transaction costs.

We have discussed the issues regarding each component of average transaction costs in our responses to questions 34 to 39. Equity broker commissions and transaction taxes are readily obtained by the methods discussed in our answers to questions 34 and 35. It is suggested on page 67 that spreads will form a part of average transaction costs but, as noted in our response to question 38, this appears to conflict with the narrative on pages 60 to 62 about extracting the commission-equivalent element from the spread. Nevertheless, whichever approach is adopted, the relevant figures should be provided in a centralised table which the fund manager can use to calculate a weighted average based on the portfolio composition at the end of the period. Our reasons for recommending a centralised table are given later in this answer. We do not agree with including market impact for the reasons given in our answer to question 39. As discussed in our answer to question 37, we do not agree with the suggestion on page 67 that dealers know typical spreads as part of their best execution obligations.

In suggesting a methodology we support the ESAs approach of drawing on the joint DWP/FCA Call for Evidence. This is a positive step for ensuring consistent approaches are used for calculating transaction costs. However, there are significant differences in the objectives: the KID is a pre-sale document, aimed at retail investors, containing an ex-ante high level summary of costs; whereas the reporting being developed jointly by DWP/FCA is intended for use by the governance bodies of workplace pensions on an ex-post basis to review transaction costs at a granular level and assess whether they offer value for money for members. The precursor to this reporting was the Office for Fair Trading's defined contribution workplace pension market study (the OFT report) published in September 2013.

According to page 65 of the TDP, the main disadvantage of standardised models is that they give limited ability to put pressure on providers to get value for money from the transaction costs. This conclusion is taken from the DWP/FCA Call for Evidence. Whilst this is relevant to governance bodies, it is irrelevant in the context of the KID. The purpose of the KID is to enhance retail investors understanding and facilitate comparison of PRIIPs, not to exert pressure on costs. Indeed, such pressure would run a dangerous risk of creating unintended incentives. Unit transaction costs are largely fixed and the key variable driving the magnitude of transaction costs is trading activity; put simply the more a fund trades the higher the transaction costs will be. It follows that the most significant way of reducing transaction costs is to trade less and this creates an undesirable incentive for fund managers.

In the UK, the OFT report recommended developing a commonly defined single charge metric to facilitate the comparison of workplace pension schemes and that transaction costs should be omitted from this single charge. The OFT took the view that "their inclusion could potentially create incentives for investment managers to avoid carrying out transactions in order to keep costs down, even where this is contrary to the member's interest." It is for this reason that we recommended separate summary indicators for ongoing charges (as currently defined for the UCITS KIID) and transaction costs.

It is suggested on page 65 of the TDP that disclosure of actual costs facilitates a better understanding of the true costs and makes it clearer which costs the fund manager can control. The purpose of the KID is to inform potential investors of what they can expect to pay, and it is therefore questionable whether actual costs are any more informative than standardised costs. Indeed, the significant influence on trading activity of the level of transaction costs is likely to swamp the spurious accuracy of actual costs. The preceding paragraphs highlight the dangerous incentives to not trade that arise if there is excessive focus on the fund managers' control of transaction costs.

2. Performance fees (caption (h))

Question 42:

Do you think that an explicit definition of performance fees should be included?

Do you think the definition by IOSCO is relevant in the specific context of the cost disclosure of the PRIIPs Regulation?

No, we do not think an explicit definition is necessary or desirable. The concept of a performance fee is sufficiently well understood and has existed in regulatory parlance for many years. There is a risk that by trying to create a definition, hard lines are drawn which allow circumvention of the regulatory objective.

We do not like the IOSCO definition and do not think it is relevant. In attempting to create a definition IOSCO has created limitations to the way a performance fee model is designed and operated, speculated about why a performance fee might be used and restricted who can benefit from a performance fee. These limitations make the definition inappropriate for use in the PRIIPs context because the objective of the KID is to facilitate transparency and not to restrict the design of fee structures. There is also a risk that a rigid definition causes a certain type of fee to be outside the disclosure regime.

Question 43:

What would be the appropriate assumption for the rate of returns, in general and in the specific case of the calculation of performance fees?

The rate of return is only one part of the calculation of performance fees. It is also necessary to consider the effect of the benchmark or hurdle and the use of a high watermark. Performance fees are by their nature complex and creating complex estimates and assumptions in order to calculate a figure for an outcome that is likely not to arise does not help consumers. Whatever rate is assumed, the figure, its underlying assumptions and warnings that it will be different in reality, make it less likely to be understood by consumers compared to presenting a simple formulation indicating that if the manager does well, the manager gets to keep 20% of returns in excess of target.

Question 44:

Which option do you favour?

Do you identify another possible approach to the disclosure and calculation of performance fees in the context of the KID?

Of the options presented we prefer option 3 where performance fees are not included in the aggregate costs figure. Performance fees are contingent costs and should be presented as a separate summary indicator. This is necessary in order that the obligations under MiFID II to explain the estimates and assumptions used can be met within the context of the figures to which they relate. Moreover, ESMA's final advice differed to the draft advice in the annexed table of costs reflecting that performance fees are fundamentally different to ongoing charges. The final advice categorised performance fees as a separate type of cost whereas in the draft advice they had been included as a form of ongoing charge. We think it would be helpful if the summary indicators in the KID were aligned with the rows in the annexed table of costs in the MiFID Delegated Acts.

However, we do not agree with the suggested calculations. It is counterproductive performing calculations using historical data that is unlikely to be repeated and estimates that are inherently error prone. It would be far more meaningful to follow the UCITS approach, which is also appropriate in the context of new funds, and simply set out the key parameters for the performance fee: "the manager keeps 20% of any outperformance of the target."

Questions 45 – 80

We did not answer these questions.

3.2 Aggregating the costs

General issues

Question 81:

Should this principle be further explained / detailed?

Should the terms "rank pari passu" be adapted to fit the different types of PRIIPs?

We think this principle needs further detail. The term pari passu relates to the rights of holders of securities and describes a situation where all rights are equal and without preference. Most UCITS offer more than one share class and, by definition, the classes rank pari passu because each investor has a proportionate interest in the value of the UCITS. However, the most common distinguishing factor between the classes is that they charge different fee rates. Therefore it would be inappropriate to perform a single calculation for them.

We note that the principle has been taken from the CESR guidelines, but the essential, and prevailing, reference to the Article 26 of the KIID Regulation has been dropped. Article 26(3) specifies that a representative class may be selected to represent other class(es) provided it is fair, clear and not misleading. Using a representative class to represent a class with different costs is unlikely to pass this test.

We recommend that the principle is replaced with something based on the representative share class provision in the KIID Regulation.

Monetary vs Percentage terms

Question 82:

What should be the relevant figure for the initial invested amount to be taken into account for the calculation of cost figures?

Should a higher initial investment amount be taken into account not to overestimate the impact of fixed costs?

How should the situation of products with regular payments be taken into account for that specific purpose?

(Would an invested amount of 1 000 euros per period of time be a relevant figure?)

The amount invested should be a fixed number of the currency units relevant to the investor in question. It is not appropriate to translate, say, €10,000 and require KIDs presented to UK investors using an assumed invested amount of £7,092. It would be preferable to show £10,000. For funds, we think an amount of 10,000 currency units is appropriate as a one-off contribution.

We agree that the amount should not be so small that it overstates the impact of fixed costs, but also it should be an amount that the target clients for a PRIIP can reasonably be expected to contribute.

On balance we think 1,000 currency units per month is the most appropriate figure for regular savings. Although this is potentially on the high side, we think 100 would be too low. We think figures in between would lack the easy scalability of round numbers of 10, 100, 1,000, and so on.

Question 83

We did not answer this question.

3.2.1 Summary indicators

3.2.1.1 Total Cost Ratio (TCR)

Question 84:

Do you agree with the abovementioned considerations?

Which difficulties do you identify in the annualisation of costs?

We do not believe that the TCR is a valid indicator of the compound effect of costs and therefore it does not fulfil the requirements of the PRIIPs Regulation. The TCR is calculated by simply adding together the different cost elements but, in financial terms, compounding is widely understood to involve the iterative application of a factor over time. In the context of costs it requires the costs in year two to be calculated based on the principal amount after deducting the costs for year one, and so on. The remainder of our comments on TCR are subsidiary to our belief that the RIY is the most appropriate measure of the compound effect of costs.

We agree that it would be essential to develop a new term in order to preserve the established definition of the OCF as used in the UCITS KIID and allow for its use as one of the summary indicators in the KID.

We support the derivation of the UCITS model to ensure that the figure is, or remains, reliable. However, we recommend replicating Article 24(2) of the KIID Regulation instead of the text taken from the CESR guidelines. Article 24 states that "Where the 'ongoing charges' … are no longer

reliable, the management company shall instead estimate a figure for 'ongoing charges' that it believes on reasonable grounds to be indicative of the amount likely to be charged to the UCITS in future." (Our emphasis). It is this requirement that turns the OCF from being purely ex-post into a reliable ex-ante indicator.

We agree that the TCR figure would be sensitive to the scenarios or assumptions chosen but we believe the RIY, calculated in accordance with our recommendations in our answer to question 95, address these issues and resolve any difficulties in the annualisation of costs.

Question 85:

Which other assumptions would be needed there?

In the case of life-insurance products, to what extent should the amortization methodology related to the amortization methodology of the premium calculation?

To what extent should the chosen holding period be related to the recommended holding period?

We are not aware of any other relevant assumptions.

Holding period assumptions present conflicting issues. In order to compare products it is necessary to present standard holding periods but this may mean presenting periods that are not appropriate or relevant to some products. However, allowing recommended holding periods allows providers to show the most favourable scenarios and hide periods where the costs are high. On balance, in association with our preference for using RIY, we recommend using standard periods of one, three, five and ten years and, for products with a fixed term, the term.

Question 86:

This definition of the ratio is taken from the CESR guidelines on cost disclosure for UCITS. Is it appropriate also in the case of retail AIFs?

Should it be amended?

Another approach to calculate these costs is to calculate the ratio of the total of these amortized costs to the invested amount in the fund. However in that case the question remains as to how to aggregate this ratio with the on-going charges ratio. Another possible approach could be to use the ratio between the total amount of costs over the holding period and the average net investment (assumed during the whole period, in order to take into account future additional investments, partial withdrawals, payments (i.e. programmed investments or disinvestments)). Do you think this approach would be appropriate?

The CESR guidelines are as likely to be as relevant to retail AIFs as they are to UCITS.

The CESR guidelines do not provide for the amortisation of entry-exit costs. We would prefer summary indicators of entry and exit costs to be provided on the same basis as in the KIID Regulation which requires the maximum percentage which might be deducted from the investor's capital commitment. These percentages can readily be used in the RIY calculation and are suitable parameters for use in fund calculators.

Where regular known investments or withdrawals are known they should be taken into account but this statement is most relevant to the RIY calculation.

Question 87-88

We did not answer these questions.

Question 89:

This definition of the ratio is taken from the CESR guidelines on cost disclosure for UCITS. Is it appropriate also in the case of retail AIFs?

Should it be amended?

Another possible approach could be to use the ratio between the total amount of costs over the holding period and the average net investment (assumed during the whole period, in order to take into account future additional investments, partial withdrawals, payments (i.e. programmed investments or disinvestments)). Do you think this approach would be appropriate?

The CESR guidelines are as likely to be as relevant to retail AIFs as they are to UCITS.

We would prefer the KID to include a summary indicator for ongoing charges defined as it currently is for UCITS. This would provide a figure that can readily be used in the RIY calculation and is suitable parameters for use in fund calculators.

Where regular known investments or withdrawals are known they should be taken into account but only in the RIY calculation.

Question 90:

These different aforementioned principles are taken from the CESR guidelines on cost disclosure for UCITS.

Is it also appropriate in the PRIIPs context?

Overall we recommend the CESR guidelines as a basis for calculating ongoing charges but not for calculating a TCR. We prefer the RIY methodology.

Question 91 – 92
We did not answer these questions

3.2.1.2 Reduction in Yield (RIY)

Question 93:

Do you identify any specific issue in relation to the implementation of the RIY approach to funds?

No. We think the approach is straight forward for funds. RIY is a more complex calculation than TCR but is easily within the capabilities of PRIIPs providers. Ultimately the algorithms will be built into fund calculators and it is worth noting that these will rely on sufficiently granular data in order for the algorithms can combine the cost metrics with the relevant assumptions. It would be beneficial if the KID contains sufficient mandatory granularity in the summary indicators to ensure fund calculators can perform to their best potential. It is for this reason that we recommend a separate

summary indicator for each type of cost where the type of cost should be determined by the underlying driver of that cost. As discussed in our answer to question 26 of the first DP, we believe the appropriate summary indicators are the same as those in the UCITS KIID with the addition of an additional indicator for total transaction costs and, in the case of products with structural borrowing, an additional indicator for finance costs.

Question 94

We did not answer this question

3.2.1.4 Cumulative effects of costs

Question 95:

Do you agree with the above-mentioned assessment?

Should the calculation basis for returns be the net investment amount (i.e. costs deducted)?

Do you identify specific issues in relation to the calculation per se of the cumulative effect of costs?

We are concerned with the terminology and imprecise drafting used in the assessment. The section heading, the discussion and the question refer to "cumulative effect of costs" whereas the PRIIPs Regulation requires the "compound effect of costs" to be shown. As discussed in our answer to question 84, compounding is widely understood to involve the iterative application of a factor over time and this is a different concept to the cumulative effect of costs which relates to adding costs together. It is the need to show the compound effect that makes it appropriate to use the RIY instead of the TCR in the KID.

The first sentence on page 114 of the TDP asserts that the KID must include costs to "show the compound effect of costs on the capital investment and on returns." According to the PRIIPs regulation the requirement is to show the compound effect on the investment. Returns are not mentioned. As an example of why this matters consider a net return of nil after deducting costs of 1%. The effect of costs on returns is 100% but the effect of costs on the investment is 1%.

We agree with the ESAs that there are several issues with setting growth parameters and we recommend that the obvious solution is not to do so. The purpose of the costs disclosure in the KID is not to illustrate viable outcomes for each PRIIP reflecting growth rates it is to show the compound effect of costs. Assuming a growth rate should be considered only if it gives better information than not assuming a growth rate. We do not believe it does. We note the ESAs identify an approach of assuming zero growth but we think this would be too pessimistic as it would simply show the invested capital withering away. We recommend a variation whereby the "cost hurdle" is calculated. This would be based on an assumption that the investor will get back exactly the amount invested and the cost hurdle represents the yield required in order to compensate for costs.

It might be argued that this gives rise to more complicated calculations that investors cannot understand. However, investors do not need to understand or reproduce the calculations, only to be able to rely on the outputs. Ultimately the algorithms will be built into fund calculators and these will be easier to use and understand if they require as few assumptions as possible. The Annual Percentage Rate (APR) commonly used to compare compound interest is an example of a trusted indicator but it is unlikely that many consumers can understand or recreate the calculations behind it.

Specific issues arise in relation to performance fees and transaction costs. However, the cost hurdle approach helps to resolve these. In the context of performance fees, the absence of a rate of return assumption makes a further assumption about the extent to which the assumed return exceeds an assumed target return irrelevant. Therefore there is no performance fee in the cost hurdle. Moreover, the cost hurdle can be viewed as the null hypothesis in which the capital invested is merely held and returned at the end of the period. The absence of a need to trade in this scenario eliminates the need to assume a level of trading activity and therefore eliminates assumed transaction costs. We believe that performance fees and transaction costs should be disclosed as summary indicators but not included as part of the cost hurdle. We think that the cost hurdle is the most reliable and salient indicator of the compound effect of costs on the investment.

Question 96 – 99

We did not answer these questions