

Retail Disclosure Consultation

Financial Services
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RE: Response to PRIIPs and UK Retail Disclosure: A consultation

We welcome the revocation of PRIIPs and the empowerment of the FCA to develop a new retail disclosure regime. PRIIPs was a well-intentioned and ambitious project but the various problems described in the consultation paper, plus the use of overly complex and untested methodologies for the calculation of all three technical aspects of content – risk, reward and cost – resulted in failure to deliver a viable regime. We support the new direction of travel set out in the HM Treasury paper. We encourage the UK authorities to pursue as much international alignment as possible while resetting the disclosure regime to provide a more engaging, meaningful, and decision-useful experience, tailored to retail investors needs in an increasingly digital environment.

In our response, we set out our views on what is a challenging balance between three key objectives. First, preserving investor choice by ensuring the UK remains an open market for overseas funds. Second, maintaining a level playing field for UK funds, both domestically and internationally as they seek to compete. Third, ensuring appropriate levels of investor protection for UK citizens where wider choice may not come with the safety nets provided by the ombudsman and the compensation scheme.

We would also like to see the FCA's powers extended to include a reassessment of MiFID II costs and charges disclosure in the interests of a cohesive disclosure regime, while recognising the need to prioritise effectively in an exceptionally crowded regulatory agenda. One particular example of the distortive effect of MiFID II and PRIIPs has been the treatment of investment trust charges in certain types of fund. We provide more detailed comments on some of the key technical issues in our response to the FCA Discussion Paper. All of our proposals rest on an ongoing commitment to full transparency.

Yours sincerely



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PRIIPs and UK Retail Disclosure

RESPONSE TO CONSULTATION

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £10 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 46% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

The PRIIPs Regulation

1. Do you agree with the description of the various problems with the PRIIPs Regulation as stated above? Are there any other aspects of the regulation that you would like to raise as the government moves beyond PRIIPs into a new retail disclosure regime?

We welcome the Government's decision to revoke and replace the PRIIPs Regulation, and we agree with the various problems as stated in the consultation paper. PRIIPs was a well-intentioned and ambitious project but serious issues with its implementation were clearly apparent even before its delayed initial application and attempts to find workable solutions ran into political roadblocks. The UK authorities have acted to mitigate the most serious flaws and to protect UCITS investors from the PRIIP KID pending the development of a better alternative. We agree with the views expressed by Government about the need to step away from a prescriptive one-size-fits-all approach and reduce unnecessary burdens for firms, while upholding consumer protection.

Aside from the various problems described in the consultation paper, it is important to learn lessons from the processes that led to the introduction of the flawed methodologies underpinning the calculations of transaction costs and performance scenarios. Specifically, the customer testing of the design of the PRIIP KID, although extensive, focused entirely on presentation and did not consider any methodologies and approaches that customers may have found more helpful and insightful. The methodologies were not subjected to robustness testing, such as pilot projects, or to direct customer testing.

In this respect we note that PRIIPs used complex but untested methodologies for the calculation of all three technical aspects of content – risk, reward and cost. Whilst we acknowledge Government's recent action to remove performance scenarios, we would draw attention to research¹ highlighting shortcomings in the methodology underpinning the risk indicator used by UCITS (and later adopted by PRIIPs) and recommending an alternative approach. Moreover, the untested 'slippage' methodology for calculating implicit transaction costs continues to confound investors and intermediaries alike with its technically accurate but incoherent results. Despite multiple tweaks to the methodology to mask the most visible issues, such as results which imply that sometimes transaction costs are a form of income to a fund, the methodology remains unreliable and untrusted due to inherent assumptions about unrelated market movements.

Aside from transaction costs, there are wider issues with the disclosure of costs and charges emanating from PRIIPs that are not covered in the consultation paper. It is difficult to discuss this topic without also mentioning the MiFID II framework as both regimes seek simplicity through the expression of costs and

charges in a single all-inclusive figure. In the context of pre-sale disclosure, combining different cost elements into a single-figure risks obscuring the true nature of different types of cost and thereby renders such an approach incongruent with retail investors making well-informed decisions. We return to this point in our answer to question 10 and at length in our response to the FCA discussion paper.

In summary, to deliver meaningful transparency, it is essential to distinguish between the charges for the investment product itself and the indirect costs inherent in delivering the investment strategy, such as transaction costs and costs associated with holding certain types of investments. Single-figure aggregation, although appealing for its simplicity, obscures this distinction and provides less decision-useful information to retail investors.

A new direction for retail disclosure

2. Do you agree with the principles set out in paragraph 3.1? If not, please explain.

We agree with the principles set out in paragraph 3.1 as the basis for the new retail disclosure framework. It is our long-held view that disclosures should be meaningful, simple enough to explain to retail investors, and should not employ overly complex methodologies or create undue burdens for firms.

3. Do you agree that retail disclosure should aim to ensure that an investor is empowered to make well-informed decisions related to the product that they are purchasing, rather than focusing on comparability? If not, please explain.

We agree that empowering investors to make well-informed decisions should be the primary aim of retail disclosure. The compromises made to standardise disclosures in the interests of comparability across a diverse array of types of PRIIP has left retail investors unable to compare similar products on a meaningful basis.

Although it is important for retail investors to be able to compare similar products, we do not agree with the alternative approach set out in paragraph 3.8 of standardising the format and presentation of disclosures for groups of products within regulation. In our view it should be sufficient to be prescriptive about the methodologies underpinning selective key information, such as costs, but otherwise permit sufficient flexibility for firms to tailor their disclosures to suit the needs of their target clients.

4. Do you agree that disclosure requirements should be flexible, with prescriptive requirements for format and structure only when deemed necessary by the FCA? If not, please explain.

We agree that disclosure requirements should be flexible in order to accommodate the evolution of more innovative and engaging communications with retail investors. This is particularly important given the FCA's finding that only 3% of retail investors read existing disclosure documents.² Prescription should be used only to enhance their understanding of the information given or where there is a risk of potentially misleading information being made available. As mentioned in our answer to question 3, prescription is relevant to ensure detailed calculation methodologies are consistent. In our view this is the key role of product regulation. Any prescription about how the information is presented to retail investors should be the subject of sectoral regulation, such as the rules derived from MiFID II, applicable to the firms that interact directly with retail investors.

5. Are you content with the decision to resolve the UCITS interaction through empowering the FCA to determine a future retail disclosure regime, as discussed above?

We think that FCA empowerment is the right approach to resolve the UCITS interaction. Although the UCITS KIID as a document is as rigid and inflexible as the PRIIP KID, we would note that it is more highly regarded because it standardises factual information in a meaningful, decision-useful way. In particular, it standardises the calculation of charges at an appropriately granular level that is consistent with global standards. It also illustrates past performance in a way that demonstrates the volatility of returns.

A new direction: Delivery

6. Do you agree that there is no need to maintain any PRIIPs-related retail disclosure elements in legislation? If not, please explain.

We are not aware of any PRIIPs-related retail disclosure elements that need to be maintained in legislation.

7. Upon revocation of the PRIIPs Regulation, do you agree with the government’s view that the FCA will not require any new additional powers to deliver a retail disclosure regime in line with the objectives stated in Chapter Three? If not, please explain.

We note that the overseas funds regime reserves powers for HM Treasury to determine equivalence and impose requirements on international products before they can be made available to retail investors in the UK. Therefore, there is the possibility of conflict between the design of the FCA’s future disclosure framework and government’s ambition to improve the choice of international investment products.

In our answer to question 10 we highlight the need for the FCA to have powers to address the shortcomings of the MiFID II cost and charges disclosures as part of developing a new retail disclosure regime. The FCA highlights in their parallel discussion paper that the absence of such powers reduces their ability to ensure there is a cohesive disclosure regime to a longer-term ambition. In the absence of such powers, we recommend that the FCA at least clarifies the interaction of the new regime with legacy MiFID II rules such as the interpretation of providing information by reference to the contents of the UCITS KIID and PRIIPs KID in COBS 6.1ZA.14UK and COBS 14.3A.11UK.

Wider retail investment and disclosure issues

8. Are there any wider obstacles that prevent or discourage firms from offering investment products from different jurisdictions to UK retail investors, and what actions would you suggest that the government take on this issue?

Government has set out an ambition to remove regulatory burdens in order to widen choice, observing that the PRIIPs Regulation has discouraged firms from offering overseas investment products, such as US-based ETFs, to UK retail investors, and has had a negative impact on the UK retail bond market. Firms are also encountering increasing extra-territoriality in the way in which UK fund regulation is now having to be applied to overseas funds being sold into the UK. Getting the right balance here is absolutely essential so that UK investors can access both overseas funds and domestic products in a way that ensures that the UK

remains an open market and that UK funds can remain competitive alongside their international counterparts.

In this regard, we recommend that disclosure of costs and charges should reflect international disclosure standards³ by giving primacy to a form of total expense ratio reflecting the price paid for an investment product over an aggregated all-inclusive figure that includes the indirect costs inherent in delivering the investment strategy. The latter information should always be available; the issue is how it is presented to ensure the primacy of the most decision-useful information as well as providing accountability on an ex-post basis.

A specific issue has arisen for the managers of funds seeking to invest in productive assets and infrastructure projects. Often such investments are made via undertakings that are structured such that they fall within the definition of Alternative Investment Funds under rules that implemented the AIFM Directive for example, investment trusts. The PRIIPs Regulation brought the costs of such undertakings within the scope of the requirement to ‘look-through’ and include such costs in the cost disclosures of the investing fund, and this approach has been transmitted to MiFID II as part of the expression of all costs and charges. However, prior to PRIIPs, such a ‘look-through’ was not required for these types of undertakings which has led to an increase in disclosed costs where actual costs have not changed. We understand this has resulted in considerable investor confusion, creates a risk that investors respond by making ill-informed decisions, and incentivises managers to divert their investments in productive assets and infrastructure projects to investment structures overseas. The requirements as to how to disclose these ‘look-through’ costs should be reconsidered.

We also believe one of the obstacles that prevent or discourage firms from offering investment products from different jurisdictions to UK retail investors is lack of clarity. For example, whilst the legislative framework for the Overseas Funds Regime is now in force, it remains unclear when it will be operational including when equivalence determinations will be made. This uncertainty makes it challenging for firms from different jurisdictions to make informed decisions regarding marketing to UK consumers.

9. Do you have any views on digital disclosure, and in particular to what degree do you think a less prescriptive disclosure regime will facilitate innovative disclosure formats going forward?

We agree that a less prescriptive approach is an essential precursor to more innovative disclosure formats that facilitate the layering of information, the use of interactive features and effective visual presentations. In our view the key reason that the PRIIPs framework is unsuited to digital solutions is its use of highly prescriptive methodologies reliant on multiple assumptions for calculating specific pieces of content, and its insistence on over-aggregating dissimilar items such that the ability to understand the impact of those items is lost. Effective digital solutions rely on good quality, appropriately granular, consistent core data uncompromised by assumptions.

In this respect we are disappointed that the FCA’s mandate to develop a new retail disclosure framework is restricted to product disclosures rather than taking a wider sectoral view including the disclosures required to be made to retail clients by distributors and advisers operating under MiFID II (and IDD). For cost information in particular, MiFID II replicates the over-aggregation of product charges with the indirect costs inherent in delivering the investment strategy, such as transaction costs, to the detriment of retail investors’ ability to make well-informed decisions.

In order to provide the most coherent information to retail investors, product information needs to be a standard specification of granular data items that must be transmitted to intermediaries in order that they can fulfil their onward obligations to their retail clients most effectively. Rules concerning the format and layout of documentation should be stripped out of product regulation and specified instead, to the extent necessary, in the sectoral rules (currently derived from the MiFID II framework) in a form fit for the digital

era. This may mean an appropriate level of complexity is essential to ensure an adequate representation of the core facts.

10. Do you have views on other priorities for retail disclosure reform that the government and FCA should consider in future? Similarly, are there other challenges or trends in retail disclosure that regulators and policymakers should consider?

In the context of the UK's heavily intermediated retail marketplace, it is disappointing that government has restricted the scope of the FCA's review of the future disclosure landscape to product disclosures currently enshrined in PRIIPs and UCITS rules. Retail investors generally interact with intermediaries operating under MiFID II which sets out obligations for communications with clients, especially in respect of costs and charges. In commenting on the effectiveness and consistency of cost disclosures as part of the findings of supervisory work in February 2019, the FCA said⁴ *"the interaction between [various pieces of regulation including the PRIIPs Regulation, MiFID II and the UCITS KII Regulation] in terms of detail is not always seamless and we know that not all disclosure works equally well."* There cannot be a cohesive disclosure regime without addressing the shortcomings of MiFID II cost and charges disclosures.

Any reform of disclosure, be that product disclosure or communications set out by MiFID II, should be underpinned by considerations on how to improve financial literacy, in society and especially among consumers. Research from the FCA Asset Management Market Study, cited earlier in this paper, indicates that 97% of investors do not read disclosure documents before investing. To lay the groundwork of the new framework the FCA needs to ask why that is, research consumer behaviours, and design the principles for disclosure with that in mind.

MiFID II requires the aggregation of distributors and adviser charges with the product costs provided in the PRIIP KID. It goes on to require any costs not included in the PRIIP KID or UCITS KIID also to be included in the aggregated total. Whilst it is not inappropriate to combine charges for product, distribution and advice, combining indirect cost elements such as transaction costs into a single-figure risks obscuring the true nature of different types of cost and thereby renders such an approach incongruent with retail investors making well-informed decisions. We recommend that government grants the FCA powers to address MiFID II cost and charges disclosures in order to deliver a cohesive disclosure regime.

We would encourage the FCA to use the more flexible approach to disclosure to facilitate the integration of ESG and sustainable investment information in a way that is consistent with the nature of the product and the investor base, and avoid the need for additional stand-alone documentation to be produced.

¹ [Driver, R., Patterson, J. \(2010\). Note on CESR's recommendations for the calculation of a synthetic risk reward indicator. ABI/IMA Research Brief](#)

² [Financial Conduct Authority. \(2010\). Asset Management Market Study Final Report.](#)

³ [International Organization of Securities Commissions. \(2016\). Good Practice for Fees and Expenses of Collective Investment Schemes Final Report.](#)

⁴ [FCA. \(2019\). Review on disclosure of costs by asset managers.](#)