THE INVESTMENT ASSOCIATION

Investment Association Response to DP22/6: Future Disclosure Framework

Effective communication builds trust and helps customers make good decisions. The existing retail disclosure regime has become overly complicated and increasingly unfit for purpose. The IA is supportive of proposals to repeal PRIIPs and sees this as an important moment to set a new agenda for the digital world. We set out a series of principles as to how a more consumer-focused approach would work as well as outlining a series of technical positions to help provide more meaningful, decision-useful information. While a key reference point is the UCITS Key Investor Information Document, we are not looking back, rather forward to a new environment in which paper-based documents are replaced by more customised digital formats based on a consistent underlying data architecture.

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 250 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.

Executive summary

The IA agrees with the aims and many of the principles set out in the DP. 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. When designing the future system, the IA recommends a principles-based approach which puts the customer at the centre, and which allows firms to innovate to adapt communications to best suit the target market. We see five key features of a successful future regime:

1) Communication should be built around the needs of the customer.
2) Disclosure that is proportionate to what the investor is purchasing and consistent across similar products and wrappers.

The Investment Association

Camomile Court, 23 Camomile Street, London, EC3A 7LL
www.theia.org

Reuben.overmark@theia.org

@InvAssoc @The Investment Association

3) Recognition that a one-size fits all approach across different products does not work, and the need for comparability is not absolute.
4) An element of standardisation around key metrics is important, notably charges and costs, risk and performance.
5) Greater emphasis on the use of technology to support communication; firms should be able to communicate in the way they see fit for a customer rather than a prescriptive durable medium.

Any reform of disclosure should be underpinned by considerations on how to improve financial literacy and engagement. The FCA's own research 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.

Given the scale of challenge, the process of designing a new retail disclosure framework should not be rushed. We recommend that the FCA takes time to review responses and speak with industry and consumer groups before considering a CP. It is important that all stakeholders are aligned when a future regime is put in place.

In future discussions, the IA recommends that the FCA splits out consultations on methodology from those asking about the principles of disclosure design.

We also reiterate points made in our response to the consultation from HM Treasury on revoking PRIIPs with respect to having regard to international competitiveness and the ability for overseas funds to be effectively distributed into the UK market. A balance has to be found in the UK regime that facilitates access for funds from the EU and other jurisdictions in a way that does not put UK funds at a competitive disadvantage domestically or internationally, and at the same time 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.

With respect to technical measures, many of the points made in this response can be summarised in a single observation: the UCITS Key Investor Information Document (KIID) contains the elements of the solution for future disclosure. This approach would see the following steps taken:

- Core data points that have been successful, notably a consistent definition of the Ongoing Charges Figure (OCF), should be retained as a standard format for the retail distribution chain.
- Transaction cost reporting introduced under PRIIPs and MiFID should be simplified to ensure full accountability while removing artificial distortion and misleading information.
- A re-examination of 'look-through' requirements should take place to provide more decision-useful charges information alongside underlying cost information.
- The risk indicator could be revisited to reflect more closely the risk characteristics of the investment fund rather than comparable retail offerings such as guaranteed products.
- Past performance should be retained alongside whatever narrative or additional market information would be helpful to investors to understand the connection between past and future returns.
- The prescribed length and content of the document would be replaced by a digital-ready set of requirements that focus on the five elements above plus the investment objectives, policy, and strategy of the fund.
- It is the information and not the format that should be at the heart of future manufacturer core disclosure, thereby contributing to a common data architecture to underpin consumer disclosure.

While the IA supports efforts to reform the disclosure regime, we believe this should not be rushed. The FCA should take its time to speak with industry, trade bodies and other stakeholders such as consumer groups when considering the next stages in this process, including the CP. All parts of industry need to be engaged with a new regime if it is proposed, therefore, the IA suggests the FCA look at the process of the Productive

Finance Working Group where multiple stakeholders came together to develop practical solutions to the barriers to investing in long-term, less liquid assets. A similar arrangement could be beneficial to developing the future disclosure framework.

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. The IA would like to see a wider review of the disclosure aspects of MiFID, IDD, and domestic pension regulation to provide a more holistic review for the future framework. Clearly, such an undertaking would be significant given other immediate priorities for policymakers, regulators, and industry. However, there are elements of our response here, notably around cost calculation and presentation, that will not be effective without this.

Response to Discussion Paper

Q1: What are the benefits or drawbacks of the timing of disclosure being prescribed by the FCA? Or should it be left to firms to find the right time for their target consumer?

The IA recommends that the FCA move away from a prescribed framework to principles-based regulations where firms through the distribution chain can provide disclosure which suits their target consumer. This could involve an approach where some standardised consumer-facing information is still defined so as to be consistent – e.g., charges and costs, risk and performance metrics. However, a standard format based on assumptions about a typical investor does not engage customers.

The timing of disclosure should also be based on principles of being made in 'good time' of a sale rather than prescribed. This will allow intermediaries to provide the investor with information at the right time throughout the customer journey, as opposed to overloading them with information which may cause friction.

Moving to a more principles-based approach will allow firms to increasingly innovate and compete based on the support they provide to the customer on their savings and investment journey. At the same time, by focusing on defining core metrics, we can reverse some of the damage done by the PRIIP KID which introduced too many assumption-driven data points and made it almost impossible to answer basic questions such as "what am I paying?" in a consistent and comprehensible fashion.

Q2: Will a durable medium requirement constrain your ability to deliver innovative disclosure? Are there any other rules that may constrain the medium in which information can be provided?

The IA broadly supports making communications digital for all customer communications with the appropriate safeguards to allow customers who are less digitally savvy, or who have vulnerabilities, the right to opt-out. IA members with direct-to-customer businesses report higher and closer levels of engagement if communications are sent and stored digitally rather than paper-based. Electronic communications have the benefit of being faster, more reliable and offer a higher level of security when compared to paper-based communications. Firms are also able to better understand their customer's preferences through traceability, open rates and clicks.

When looking to reform disclosure, the IA urges the FCA to look to apply similar regulation to that which is applied to the retail banking sector, which requires that communications are in the appropriate medium.[1]

[1] BCOBS 4.1 Enabling banking customers to make informed decisions.

Similar regulation for the retail investment industry will put the onus on firms to be able to determine the most appropriate approach and emphasise the information most appropriate for the customer.

Q3: Do you agree that we should future proof the disclosure requirements? How else can we do this? Do you have any views or evidence on the merits and drawbacks of different approaches to future-proofing?

Futureproofing is likely to be most effective by reducing the level of formatting prescription and focusing instead on ways in which information that can be standardised can be transmitted most effectively through the retail distribution chain. At the same time, we should recognise that both expectations (consumer, policymaker, regulator) and technology are evolving increasingly quickly and that there is a limit to what can be future-proofed in that environment.

One point, however that may help, is to focus more on effective consumer testing. We note that consumer testing was deployed for both the PRIIP KID and UCITS KIID exercise. One key feature of the problems that arose with the PRIIP KID was a disconnect between the policy direction that was eventually taken and the level of consumer testing of what became very complex concepts. Consumer testing is not a panacea, particularly when conducted on a lab basis, and we urge policymakers to heed some of the empirical findings from the retail industry itself.

Q4: How do you envision the distribution of retail disclosure changing over the next 5-10 years?

Retail disclosure is likely to become increasingly digital and automated. This shift is being driven by several factors, including the growing and changing use of technology in the retail investment industry, the increasing demand for real-time and accessible information, and the need for greater transparency and accountability. The IA envisions future retail disclosure where standardised data is provided by the manufacturers and in turn displayed by intermediaries in a format in line with the firm's obligations under the understanding and support outcomes of the Consumer Duty. This means that two firms may have different formats for displaying that data depending on their target market. The disclosure of information may even differ for two different customers with the same firm, if they are in two separate target markets. The customer should in turn have the ability to export or download a record of the information which they were given at the point of sale.

Q5: Who should have responsibility for producing retail disclosure?

As the FCA points out, product manufacturers have access to more detailed data on the product which the distributor will sell. However, the distributor will understand their target market better and therefore, under a principles-based approach, be able to produce disclosure which suits their customers.

In our view, at the heart of a future disclosure framework will be standardised data, provided to distributors for them to tailor disclosure for their customers. This will involve core product information (e.g., investment fund objectives, fees, risk, past performance). For certain types of disclosure, e.g., risk disclosure, we believe it is right for the manufacturer to take on a larger role as they will have a greater understanding of the product. This will feed into target market information provided to distributors as part of the product governance and distributor due diligence process. Manufacturers will also want to provide a range of materials relating to the investment process and fund performance. In our answer to question 19 we have cited IA consumer research showing that investors value commentary of that sort.

The key difference with the current regime will be the ability of distributors to tailor communication and not depend upon a rigid process in which both content and length is specified in regulation. All communications – whether by manufacturer or distributor – should be in line with the Consumer Duty to support and enable investors to make informed decisions about products and services, to be given the information they need, at the right time, and presented in a way they can understand.

Q6: How should it be determined that a product is suitable for the retail market and therefore that regulated disclosure should be produced? Does this need to be balanced with choice for retail investors?

Our view is that PROD already provides a sufficient governance framework for determining which investors a product is suitable for, and whether the retail market, or particular investors in this market should be targeted, and regulatory disclosure produced. The primary concern should be that there is sufficient governance in place to ensure products are only targeted at retail investors where these are suitable for those investor groups, and where this is the case that appropriate disclosures are provided – our view is that PROD in its existing form provides this framework.

There is always the possibility that a manufacturer may develop products that ostensibly would be suited to many retail investors, but for whatever reason chooses to restrict this to non-retail investors only. If so, this is their prerogative. A manufacturer should not be forced to make products available to retail investors, or to provide regulatory disclosures for retail investors if they wish to restrict the target market. In such cases, if a distributor chooses to make such a product available for a retail investor, it is reasonable that they would assume responsibility for providing the necessary disclosures for making such a recommendation against the target market specified by the manufacturer.

Another scenario is where an informed retail investor wants to invest in such a product, and a distributor facilitates this at the investor's specific request – where this is the case, it is reasonable for the distributor to seek a waiver for their liability from the investor upon the investor being warned that suitability has not been confirmed by the distributor and the manufacturer is not targeting the retail market, and therefore has not produced the regulatory disclosures normally available for retail investor.

Overall, we view these scenarios as being unlikely. There is a broad range of products designed for and made available to retail investors, allowing for broad choice in most asset classes (noting further regulatory changes are likely to address gaps such as access to private market investments). We expect that there will be limited appetite among distributors, if any, to facilitate retail access to products that the manufacturer has not elected to target retail investors and produce the requisite disclosures.

Q7: Do you agree with these principles for effective disclosure design? Are there any other principles we should assess?

We are supportive of the principles which the FCA has developed, and they align with the principles which the IA would like to see the FCA work under. The new disclosure regime needs to be built around the consumer, how to deliver disclosure just in time for a decision by a customer and needs to take into account the changing ways in which consumers absorb information. It is important for the guiding principles to require the information to also be engaging, particularly as the FCA's 2017 Asset Management Market Study found that under 3% of retail investors read regulated pre-contractual fund disclosure documents.[2]

While it is not a part of the FCA's mandate, we think that financial literacy needs to be considered as part of any changes to the disclosure framework. One of the key questions the FCA should ask itself when designing the future framework is why 97% of investors do not use disclosure documents and how to engage them through different forms of disclosure design.

Q8: Do respondents have any evidence or consumer testing results on the merits or drawbacks of different forms of presentation?

There is a wide range of evidence from regulatory testing over many years about presentation formats that work well, although in a fast-moving digital environment, there may be more to do as part of the next phase

[2] https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf

of investment fund disclosure. While forms of presentation matter, so does language. In 2019 the IA produced our Fund Communications Guidance[3] after the FCA's Asset Management Market Study's Final Report highlighted difficulty for customers in knowing what to expect from their fund and how to assess whether or not it was performing against stated objectives.

The top-level guidance issues by the IA included:

- Accessibility:
    - Fund managers should pay close attention to what may constitute 'jargon' and try to minimise this as far as possible.
    - Customers want information to be more accessible on provider websites and as up-to-date as possible, particularly execution-only customers who may also look for more accessible data than what is included in PDF attachments to manage their own spreadsheets.
- Concision and precision:
    - Short simple explanations aid customer understanding. Regardless of knowledge base, many customers can be confused by too much detail, particularly if new technical terms are introduced. Language should be precise.
    - Percentages are helpful, they should ideally add up to 100 when allocations are broken down. It is recognised that this will not always be possible, for example where investment limits are being set out.
- Narrative: A coherent and well-articulated narrative goes a long way to helping customers understand what they are buying.
- Role of layout: While there are regulatory constraints on the layout of several pre-disclosure documents our research found that they can still be improved, for example by using bullet points and section headers in bold to signpost details and aid comprehension.

On investment disclosure our research found that:

- Risk: The concept of risk is complex and not easily explained to a retail customer. When designing the future framework, more consideration should be given as to how best to describe investment risk to investors. We found that 54% of investors ranked the level of risk associated with a fund as the most important factor when taking the decision to invest. Concurrently, the research also showed that the link between risk and reward was not well understood, and divergent definitions of what risk means, with most investors defining it in largely negative terms. The same research showed that investors had a very good understanding of the term volatility and combining explanations with graphs can help investors make sense of the concepts.
- Performance and benchmarks: 87% of customers consider the fund's target return as key in helping to assess performance. IA research as well as consumer research done by members with investment platforms shows that past performance is the primary focus when evaluating funds. Consumers also want to ensure that benchmarks are comparing 'apples with apples' and that their investments are beating cash. Fund manager commentary on the performance of the fund is welcome, especially when performance has been poor.
- Time horizons: Our research showed wide discrepancies between what investors regard as short, medium and long-term time horizons for holding an investment product. In line with FCA views, our guidance concluded that fund managers should try as far as possible to be specific and reference the number of years in a time horizon. They should also make clear that the minimum term for holding units in a fund is just a minimum.

[3] The Investment Association, Fund Communication Guidance, February 2019: https://www.theia.org/sites/default/files/2019-08/20190218-fundcommunicationguidance.pdf

Q9: Evidence suggests that layering in retail disclosure can improve consumer understanding. Do you agree with this and can layering also reduce the burden on firms? Are there any challenges we should consider?

We agree. The best way to ensure that a potential or existing investor has understood the product and is taking a considered decision is through providing disclosure in a layered, just-in-time format. An obvious challenge that then arises is how to layer information in ways that cater effectively for different customer needs and their ability to interact with that information.

One of the main issues industry faces is the need to balance disclosure in a customer-friendly manner along with the necessary standalone compliance. When designing a new disclosure framework, the FCA should balance how compliance disclosures fit into, and do not disrupt, a coherent customer journey.

Once the FCA has analysed responses and has the groundwork for a future disclosure regime thought through, the IA would be happy to convene a meeting of our members and the wider retail investment industry to work through how the new disclosure framework would work in practice.

Q10: Are there other interactive disclosure approaches we should evaluate?

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. Firms should generally be free to use those forms of interactivity that they feel will work best for their customer base. Interactive tools allow customers to feel more confident throughout the journey. Members who run intermediaries have found, through consumer testing, that customers understand products considerably better, particularly risk and reward trade-offs, when using interactive tools prior to the purchase. Interactive tools allow customers to feel more confident throughout the journey.

Q11: How can disclosure requirements facilitate firms to use plain language to further consumer understanding while balancing accuracy, particularly with complex products?

We do not think that further disclosure requirements around plain language are needed. The Asset Management Market Study, Consumer Duty and various Dear CEO/Chair letters have provided a clear basis for moving forward. The IA is working closely with its firms and other parts of the distribution chain to advance the move towards plain English in consumer-facing communications.

Q12: What do you consider the appropriate balance between flexibility and prescription in disclosure? Does comparison feature in this balance?

We do see greater prescription being helpful in defining certain key data points for customers, providing that the methodology is developed and implemented in a way that facilitates meaningful information. For example, we support transaction cost information being made available, but we do not accept the validity of the slippage methodology for calculating implicit costs for mainstream disclosure and we question whether MiFID aggregation requirements lead to better information for decision-making.

Per our answers to other questions in this response, we are in favour of a principles-based, flexible approach when it comes to the format and presentation of the information to the investor.

Q13: What information, if any, should be comparable? Do you have evidence to support or refute comparability between similar product types?

Ideally, certain core information should be comparable, notably product costs, risk metrics and past performance presentation. However, there are inherent methodology challenges with some of this information, which requires pragmatism and a recognition of inevitable trade-offs.

In terms of evidence, the aggregation of product costs and transaction costs removes any form of meaningful comparability and potentially facilitates poor decision-making where it is impossible to distinguish the drivers of investment return from the fees paid to deliver the return. We are very clear in our ambition to simplify this disclosure to ensure comparability on the question of 'what am I paying?', while preserving full transparency and accountability.

We also tend to favour standard methodologies for risk metrics but recognise that this is challenging. As we note in our answer to question 16, the discussions on the standard risk framework (SRRI) for the UCITS KIID did not result in a methodology that was as stable or dependable as we would have wished to see. Our own research focused more on a way to understand the behaviour of the asset class, thereby setting out a specific approach to comparability which was more high-level but, in our view, more robust. However, for certain fund strategies, this is not optimal since it would reduce the ability to demonstrate specific approaches to risk management.

In short, comparability must be approached in a way that is technically robust and accessible to customers, while having an open and evidence-based debate about what will be inevitable compromises to achieve a workable solution.

Q14: What level of prescription should be involved in the calculation of costs to ensure clarity and consistency for consumers while also prioritising the need for accuracy?

Our overarching concern about PRIIPs has always been over-engineering resulting from both embedding assumptions rather than relying on core metrics, and a reliance on complex and unreliable calculation methodologies for some of the input data, notably transaction costs. For the future disclosure framework, we recommend a 'back-to-basics' approach that recognises the difference between data that supports full transparency, and meaningful information that supports well-informed decisions. While some stakeholders will understandably want a 'single number', we advocate a breakdown which distinguishes the charges for the investment product itself, and the indirect costs inherent in delivering the investment strategy. We expand on this point in our answer to question 15. The combination of PRIIPs and MiFID has led to distortions in presentation that are not serving the retail market effectively.

Notwithstanding our strong support for a flexible approach to the format and presentation of disclosures, the calculation of costs and charges is an area where a prescriptive approach is appropriate to ensure consistency of the information provided. In order to ensure UK products remain competitive with international products in both domestic and overseas markets, it is essential that the calculations specified reflect, and do not go beyond, established international standards and we expand on this point in our answer to question 15. It is also essential to ensure that the methodologies used produce accurate, factual results, are capable of being understood by retail investors, and avoid placing undue burdens on product providers. In this respect we recommend reverting to the UCITS KIID content and methodology for calculating charges and simplifying the calculation of transaction costs by abandoning the PRIIPs methodology for calculating implicit costs.

Q15: What are the pros and cons of presenting cost as single figure, with more detailed information layered in disclosure?

The simplicity of a single figure for costs is appealing when it can be difficult to get retail investors to engage with complex information about costs. Nevertheless, combining different cost elements into a single figure risk obscuring the true nature of different types of cost and thereby renders such an approach incongruent with retail investors making well-informed decisions. In other words, an appropriate level of complexity is essential to ensure an adequate representation of the cost structure. There are three key considerations that we make in our position on the single figure:

1. Consumer Duty: The Consumer Duty aims to ensure retail investors receive fair value. Fair value is defined as being provided where the amount paid is reasonable relative to the benefits received. In the context of an investment product, the benefit is an exposure to the risks and potential rewards of a defined investment strategy. This exposure can be obtained through a number of different types of investment product, by engaging the services of a portfolio manager, or by building a portfolio on a 'DIY' basis. The amount paid is the sum of the charges levied directly on the investor and the charges deducted from the investment product. In addition, there are indirect costs that relate directly to the investment strategy such as transaction costs, costs arising in underlying investments, and costs associated with holding physical assets. For a proper understanding of the value offered by a product, it is essential to distinguish between the charges for the investment product itself and the indirect costs inherent in delivering the investment strategy.

2. FCA research on investor behaviour: Research by the FCA[4] indicates that a high number of participants choose a cheaper fund when presented with a selection of funds on a simulated online investment platform. It also shows that less than half of participants choose to click through to additional information on charges. However, the fund sets shown to the participants were constructed so as to vary the ongoing charges figure and the total cost and charges figure (made up of ongoing charges, platform charges and transaction costs) in proportion to each other thereby ensuring the funds ranked the same on both measures of costs. In practice, these two measures are not proportionate and a fund with higher ongoing charges might have lower total costs and charges, and vice versa. This suggests that retail investors presented with a single all-inclusive total costs and charges figure are likely to choose the product with the lowest total costs without looking further to find out the actual price to be paid for the product itself, potentially leading to sub-optimal investment decisions.

3. International norms: We note the government's ambition to improve the choice of international investment products, such as US-based ETFs, available to UK retail investors by reducing the compliance burden on providers of overseas products[5]. Whilst we do not expect the imposition of prescriptive rules on cost disclosure to be imposed on such overseas products, we do expect that the forthcoming competitiveness and growth objective should ensure a level playing field for domestic products to compete both at home and abroad. In the absence of a prescriptive international standard for cost disclosure, we would recognise the relevance of IOSCO's Final Report on Good Practice for Fees and Expenses of Collective Investment Schemes[6] and the SEC's prescriptive approach to the disclosure of fees and expenses as set out in item 3 of form N-1A.[7] Subject to some technical differences, these sources have in common a primary focus on the charges for the investment product itself.

Given these three considerations, we recommend that the single figure should focus on the charges for the product itself. Additional indirect costs inherent in the investment strategy should form part of the additional detail within a layered approach but should not be included in the upfront single figure. In that way, we fulfil an objective to be fully transparent but provide decision-useful information at the appropriate stage of the decision-making process.

[4] Financial Conduct Authority. (2018). Occasional Paper 32: Now you see it: drawing attention to charges in the asset management industry.
[5] HM Treasury. (2022). PRIIPs and UK Retail Disclosure. A consultation.
[6] International Organization of Securities Commissions. (2016). Good Practice for Fees and Expenses of Collective Investment Schemes Final Report.
[7] Securities and Exchange Commission. (2022). Form N-1A.

In essence, the starting point should be a return to the headline content provided in the UCITS KIID whereby one-off and ongoing charges are presented together with an indication of the key terms of any performance fee and signposting to further information about transaction costs and arrangements for distribution fees.

IA approach to charges and costs disclosure

The remainder of this answer sets out our views on the detail of such an approach and highlights the issues it seeks to address. Our analysis starts by identifying the characteristics of each type of cost, the way it impacts the outcome for investors, and consequently whether it is useful to investors in making well-informed decisions.

<u>One-off charges</u>

One-off charges are paid directly by the investor or deducted from the proceeds of their investment before it is paid out and may be used to cover distribution costs, administration costs or paid into the investment product for the benefit of its ongoing investors. In all cases, one-off charges reduce the amount invested or the proceeds realised, and it is critical that investors are informed of the amounts to be charged in order to make well-informed decisions. In addition, it would be necessary to identify the distribution costs component separately in order to compare products on a fair basis.

<u>Ongoing charges</u>

Ongoing charges are deducted directly from the assets of an investment product and are used to pay management fees, distribution costs, and the other operating expenses of the investment product. In all cases again, ongoing charges reduce the value of the investment in a linear fashion relative to the charge. It is critical that investors are informed of the amounts to be charged in order to make well-informed decisions. In addition, it would be necessary to identify the distribution costs component separately to compare products on a fair basis. Some investors may be interested in the split between the amounts charged by the product manager and by other parties involved in operating the product.

<u>Performance fees</u>

Performance fees reward the manager of the product for achieving returns that exceed a predefined target over a predefined period, usually by paying the manager a fixed proportion of the excess returns generated. As such they are often thought of as a form of profit-sharing and it is critical that investors are informed of the key terms (proportion, target, period) of a performance fee in order to make well-informed decisions. Behind the scenes of any well-designed performance fee, there will be detailed consideration of the incentives created and their alignment with the fair treatment of investors.

<u>Transaction costs</u>

Transaction costs arise when investments are bought or sold for the product and are a necessary and unavoidable part of delivering the investment strategy. A well-informed investor needs to understand the price for the product relative to the benefits in the form of the exposure to the risks and potential rewards of a defined investment strategy. The manager of the product is judged on their delivery of the investment strategy, which is a combination of making and implementing investment decisions. Transaction costs are the costs of implementing the strategy and, as they reduce the overall returns generated, managers are incentivised to minimise them.

The significance of transaction costs can be judged in the context of the amount traded and the cost per trade which contributes to the total. All things being equal, a more actively traded strategy will incur higher transaction costs than one that is less actively traded. The benefits to investors lie in being exposed to the strategy that delivers the best returns, but the level of transaction costs is not indicative of which one that will be. At the time of investment there is an equal likelihood of both the more and less active strategies outperforming the other, but the FCA's research[8] has shown there to be strong bias towards selecting the product with lower costs. Therefore, transaction costs are not decision-useful information at the pre-sale stage of an investor's journey and should be viewed as a part of the delivery of a product's benefits rather than portrayed as part of its price.

The incentive for managers to minimise transaction costs when they trade is reinforced by best execution rules. Transaction cost analysis techniques are used to ensure that the difference between the price at which a manager decides to act on an investment idea, and the execution of the trades required to implement that idea is minimised. This difference is known as 'implementation shortfall' and represents factors affecting the price of the security (bid-ask spread, market impact, opportunity costs) and the explicit costs of undertaking a transaction (commission, tax). Once best execution is achieved, the only way to reduce transaction costs is by trading less. In 2013, the Office of Fair Trading[9] recommended that transaction costs should not be included as part of a single charge figure because "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."

Transparency of transaction costs is an essential part of full cost transparency and should be included in periodic reports to ensure managers remain accountable for all the costs they incur on behalf of investors. But this is not the same as being decision-useful at the point of sale where investors need a clear indication of the charges that represent the price of the product, and where behavioural biases make pre-sale transaction cost information potentially misleading.

A final point on transaction costs relates to the distinction between explicit and implicit costs. We have consistently stated that while we are supportive of full transparency across all types of cost, the methodology used under current UK and EU rules for implicit costs (the so-called 'slippage' methodology) is highly undependable and misleading.[10] This has particular consequences for aggregation, adding more complexity and unreliability to numbers that are already challenging to understand.

<u>Physical asset-related costs</u>

Physical assets, such as real estate, require ongoing activities to be performed to protect and maintain their fabric and provide the necessary utilities and services to support their tenants. A dilapidated or poorly serviced building will have a lower rent potential than one that is well maintained and serviced, and it follows that the related costs should be viewed in this context rather than as part of the product costs. This has been recognised previously by government in the context of the defined contribution workplace pensions market where such costs are excluded from the default strategy charge cap. It also aligns with an institutional investor-led initiative to establish a standardised Total Global Expense Ratio (TGER) metric[11] across the US, Europe and Asia that separates product costs as the primary metric distinct from property-related costs. Physical asset-related costs are a form of indirect cost related directly to the investment strategy and should be viewed as a part of the delivery of the product's benefits rather than portrayed as part of its price.

<u>Synthetic costs</u>

Synthetic costs are the ongoing charges of other investment products held as part of a product's investment portfolio. They reduce the overall returns generated by a particular holding, but they are considered by managers in the context of the potential value to be derived from holding the investment. Therefore, in

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[8] Financial Conduct Authority. (2018). Occasional Paper 32: Now you see it: drawing attention to charges in the asset management industry.

[9] Office of Fair Trading. (2013). Defined contribution workplace pension market study.

[10] A summary of our views can be found here: https://www.theia.org/sites/default/files/2019-04/20190425-costsandcharges.pdf

[11] ANREV, INREV, NACREIF & PREA. (2019). Total Global Expense Ratio: a globally comparable measure of fees and costs for real estate investment vehicles.

principle, they are a form of indirect cost related directly to the investment strategy and should be considered as a part of the delivery of the product's benefits rather than portrayed as part of its price.

Funds of funds employ a strategy of investing in other funds or investment products as a way of implementing asset allocation decisions. They involve a structure where fees are charged to the fund of funds and to the underlying funds or products which requires a departure from the general principle. In this respect it is considered good practice[12] to disclose a 'synthetic' fee metric that combines the ongoing charges or total expense ratios of each of the underlying products with that of the fund of funds. This approach has been mandated in the US by the SEC[13] and the EU as part of the UCITS KIID.[14]

MiFID and PRIIPs have created issues for 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 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 overseas territories.

The same issue arises in the case of index-tracking funds. For example, an investor might compare the price for two funds – one tracking an index including investment trusts and the other tracking the same index but excluding investment trusts. In both cases, the outcome for the investor will be the return of the index less the product charges. If the 'look-through' to the costs of the investment trusts in the inclusive index were factored into the product charges, the charges would appear higher on a like-for-like basis making investors more likely to select the exclusive product. However, at the time of investment there is an equal likelihood of either product outperforming the other which means that synthetic costs are not decision-useful information at the pre-sale stage of an investor's journey and should be viewed as a part of the delivery of a product's benefits rather than portrayed as part of its price.

Q16: What level of flexibility should there be in the calculation and presentation of costs and risks?

These are areas which benefit in principle from standardisation of underlying methodologies, but great care needs to be taken when developing these methodologies. For this question we have focused our answer on risk, as we have already provided our commentary on cost in our answer to question 15.

On risk, the IA has undertaken extensive research in the past in the context of standardised metrics. Our general view, similar to that on costs, is that standardisation can be helpful where the underlying methodology provides accurate and helpful insights, but there are inevitable trade-offs.

A central problem with the PRIIP Summary Risk Indicator (SRI) is that it aims to communicate about different risks in different kinds of products, including credit risk. It is probably impossible to expect it to provide a universal framework that would function well. One feature of the SRI is that investment funds could look less

[12] International Organization of Securities Commissions. (2016). Good Practice for Fees and Expenses of Collective Investment Schemes Final Report.
[13] Securities and Exchange Commission. (2022). Form N-1A.
[14] Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council.

risky than under the UCITS Synthetic Risk and Reward Indicator (SRRI), which is based purely on historic volatility.

While historic volatility is itself not a sophisticated measure, it can be helpful in communicating risk. The challenge with the SRRI in turn was that the methodology originally proposed provided risk classifications based on relatively short assessment periods and on data from funds not asset classes. Research undertaken for the Investment Management Association (the predecessor to the IA) and the Association of British Insurers by Cass Business School and Fathom Financial Consulting reached a different conclusion about how to construct the SRRI[15]:

- The risk rating engine should be based upon appropriate historic return data spanning at least ten years to calculate a volatility-based measure of risk, as increasing the span of the data significantly improves the stability and reliability of the risk metric.
- Standard deviation is the best method to use to calculate the risk metric, as it produces the most consistent rankings over time. Using standard deviation, the average correlation between the rankings for 23 asset classes and their ranking observed in the following period was 84% - higher than for any other metric.
- The risk rating process should be based upon the risks inherent in broad asset classes, rather than on data for the returns of individual funds.

The IA still believes that these findings are relevant as we continue to discuss both risk metrics and how to think about performance scenarios, since alongside past performance (see answer below), it might be useful to present metrics about the long-term behaviour of relevant markets.

Q17: What is the purpose of performance disclosure?

The purpose of performance disclosure in investment is to provide information about the historic performance of an investment to potential and current investors. While we accept that investors should not put excessive weight on past performance, it is important to recognise that this is nonetheless a valued dataset. It can help consumers understand better the behaviour both of a market and the effectiveness of a given strategy within that market.

In this regard, the testing for the original UCITS KIID reached a pragmatic conclusion in stating that: "It would appear that past performance information will be used by some to judge likely future performance…..While this could be used as a reason for excluding this information from the KIID altogether (and indeed some intermediaries were keen to see this information removed for this reason), *it was clear that this was information that consumers expected to see.*"[16]

Therefore, for the IA, the question is not whether or not to disclose past performance, but how to do so in a way this is most helpful for consumer, especially in the context of accountability.

In 2019 the IA published guidance for members on Fund Communications[17]. For this publication we undertook consumer research which found that 87% of consumers consider the fund's return target as key in helping to assess performance. The research also showed that:

[15] ABI and IMA, *Development a Risk Rating Methodology: Report from CAMR, Cass Business School and Fathom Financial Consulting*, 2010

[16] IFF Research and YouGov, *UCITS Disclosure Testing Research Report,* prepared for the European Commission, 2008. p.13.

[17] The Investment Association, Fund Communication Guidance, February 2019: https://www.theia.org/sites/default/files/2019-08/20190218-fundcommunicationguidance.pdf

- A combination bar chart and annual performance comparison to the relevant benchmark was seen as the most effective way to show performance track record and to highlight periods of under and over performance.
- Customers want commentaries on performance (this is particularly relevant to fund factsheets), especially when performance has been poor, in which case they want an explanation of why performance has been poor and what the manager plans to do to address the situation. The more directly the commentary is seen to come from the portfolio manager, the better, in customers' eyes.

Q18: To what extent should the FCA prescribe the performance information to be provided to retail investors? Should the FCA categorise products for the purpose of performance disclosure?

As we note in our previous answers, consumer research has in the past supported the assertion that customers both find past performance information useful and understand its limitations with respect to the connection with future returns. Whatever the precise methodological approach taken in future, regulators must avoid the path taken in the PRIIP KID where past performance was proscribed. As we note in Q16 and Q17, it may be that using data on long-term market performance, and displaying that data in multiple ways, can help provide a way for consumers better to understand both risk and potential returns of different asset classes. For example, the UCITS KIID includes information on discrete one year investment returns over ten years which illustrates the variability of returns over time.

Once the FCA has developed the principles for the future disclosure framework, the IA would be happy to convene our membership, alongside the wider retail investment industry, for workshops to explore how the new disclosure regime would work in practice.

Q19: Would tailoring or flexibility promote accuracy and enhance consumer engagement?

Experience from other sectors of the economy suggests that consumer engagement now depends increasingly upon tailoring, which by definition involves some degree of flexibility.

We completely agree that a range of information about redress and compensation should be presented at the appropriate stage of the journey. While we fully support complete disclosure and high standards of customer protection, we observe that the retail funds investment experience is disproportionately onerous compared to the online experience available to the many UK citizens currently using cryptocurrencies as a source of investment opportunity. Some of the responsibility for operational frictions lies with the industry itself as firms modernise the customer experience (e.g., transfer and registration times), but there is also an opportunity in the current debate to look again at the regulatory frictions through the disclosure and sales process.

Q20: Are there other content requirements that should be included in regulated disclosure? Should this content be disclosed alongside product information?

The reference to ESG and sustainable investment disclosure raises the issue of consumer overload as regulators and industry seek to define a framework in which a wide variety of content and data points are communicated to potential and existing retail consumers. We reiterate a point made in our response to CP22/20 that additional factsheets in such cases may not be the right way forward. Instead, firms should have the flexibility to integrate information in a way that is consistent with the nature of the product and the investor base. Moving away from prescribed length and content will help to facilitate this while maintaining the principle of core standardised data, as appropriate.