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Invested in America

| asset management group

28 September 2018

Retail Distribution Policy
Strategy & Competition
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

Re: FCA Call for Input: PRIIPs Regulation – initial experiences with the new requirements

Dear Sirs

The Asset Management Group of the Securities Industry and Financial Markets Association ("AMG") appreciates the opportunity to provide feedback on the Financial Conduct Authority's ("FCA") call for input on the PRIIPs Regulation.

The AMG brings the asset management community together to provide views on U.S., European and global policy and to create industry best practices. AMG members are US, UK and multinational asset management firms with combined global assets under management exceeding $39 trillion. The clients of AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.[1]

On behalf of its members, the AMG has three key points to feedback to the FCA on the PRIIPs regime:

1. **Transaction costs:** The PRIIPs arrival price / slippage methodology for calculating transaction costs does not work (particularly for non-equity products) and is resulting in misleading costs figures being reported to investors. We recommend the adoption of alternative spread based methodologies instead, which in our view will be a more representative measure of transaction costs. To ensure harmonisation, we would recommend that this approach is also adopted for the calculation and disclosure of transaction costs in workplace Defined Contribution (DC) pensions.

2. **Performance scenarios:** As calibrated, the PRIIPs rules on performance scenarios give a misleading and distorted impression to investors of future fund performance. We recommend that the PRIIPs regime be amended to allow for past performance data to be disclosed instead of, or at least in addition to, the performance scenarios, so that investors have a more reliable and transparent reference point to assess the fund's performance (i.e. its previous track record).

3. **Delay for UCITS and non-UCITS retail funds:** Finally, we recommend that the Article 32 exemption for UCITS and non-UCITS retail funds from the requirement to prepare a KID, is extended until the issues with the PRIIPs Regulation have been resolved. We consider this to be in the best interests of investors (given the potential for misleading disclosures) and the industry (from an implementation costs perspective – as these funds will effectively have to implement the regime twice).

[1] For more information, visit http://www.sifma.org/amg.

We have set out our reasoning for these recommendations, in further detail below.

1 Transaction costs

1.1 The AMG and its members are supportive of the enhanced costs disclosure that the PRIIPs Regulation aims to provide investors. However, in our members' experience, the arrival price / slippage methodology is not an effective capture of implicit costs as it consistently generates misleading figures that distort the overall cost profile disclosed in the KID.

1.2 Unlike explicit brokerage fees and product charges, we note that implicit transaction costs are difficult to quantify, as they are embedded within the bid-ask spread of certain financial instruments. The arrival price / slippage methodology attempts to capture these embedded costs, but goes further as it also looks to pick up the underlying market impact / risk associated with the trade (i.e. the opportunity cost of the trade potentially being executed at a better price from the moment it was sent into the market, compared to its realised execution price).

1.3 As the FCA noted in the Call for Evidence, this introduces an element of randomness into the calculation, which in our view is not appropriate for a costs methodology that ultimately determines disclosure to retail investors. We also strongly disagree with the FCA's view that this randomness cancels itself out when slippage is calculated over many transactions. In our members' experience, the slippage / arrival price methodology often and consistently results in negative transaction costs figures (which would lead investors to believe that these costs are in fact gains rather than leakages their fund investment has incurred) or results in figures that in their view significantly misrepresent the fund transaction costs. In the context of fixed income trading specifically, the issue is particularly acute as bonds are traded very infrequently compared to equities (e.g. once a week) and so even on the FCA's position, there is not much scope for the randomness to cancel itself out.

1.4 Depending on factors such as market conditions and/or the manager's trading strategy, a slippage methodology will very easily distort the transaction costs associated with particular trades. By way of illustration, Manager A sends a limit order in the morning to rest until the price of Share X hits £50 and Manager B sends the same order into the market when the price hits £50 – the slippage / arrival price methodology will represent Manager A and Manager B's transaction costs very differently (as Manager A's order has been in the market for a much longer period) even though both Managers achieve the same costs outcome for their client.

1.5 Similarly, a manager with a VWAP strategy may be trading efficiently at prices close to VWAP throughout the day. However, when this trading activity is measured under the current PRIIPs rules, the arrival price methodology could suggest high slippage and transaction costs (because of when the order was sent to, or how long it rested in, the market), even though the manager has been trading very efficiently compared to VWAP.

1.6 The methodology also assumes that there is continuous liquidity in the market for all product types, when in fact this is not the case for most OTC trading. An order for fixed income securities sent to a broker at 11 am, may only be executed at 2 pm because that was the earliest point at which liquidity was available. There isn't therefore an opportunity cost or market impact associated with that trade - it would not have been executed at a different point or price from the moment it was sent into the market. Instead the transaction cost is

represented within the bid-ask spread, which in our view is what the PRIIPs calculation should focus on for these products.

1.7 For the same reasons, outside of the liquid equities market, the data set required to perform arrival price calculations does not exist. As noted previously, most bonds are traded on an infrequent basis compared to equities and intra-day prices are rarely available. Although the PRIIPs methodology allows firms to use the opening price on the day of the transaction or the previous day's closing price, even that data does not exist for most bonds. Some service providers in the market do provide pricing sources and benchmarks for bonds – however these generally have significant gaps in the products / product types covered and don't generally provide continuous pricing. As such there is no reliable source of data in the market that would support or even justify adopting a slippage / arrival price methodology for fixed income instruments.

1.8 We note that managers across the industry have incurred great cost in attempting to source reliable data for the arrival price methodology (not just for fixed income products, but equities as well). However, given the issues with the methodology noted above and the misleading costs figures that are being generated, we don't think there has been any corresponding benefit to investors.

1.9 In our view, the arrival price methodology should be replaced by a spread methodology that focuses on the bid-ask spread to estimate the typical cost of a transaction (rather than approximating trading costs based on realised execution prices, which as noted above, incorporates market fluctuations and an element of randomness into the calculation). One solution could be for the arrival price to be defined as the mid-market price at the point of execution (including for child orders) rather than when the order is sent into the market. A better solution would be to adopt an enhanced spread methodology that estimates the typical cost of a transaction by reference to additional factors such as the product type, investment strategy and target holdings of the fund.

1.10 To ensure a harmonised approach and avoid the risk of misleading market disclosures, we recommend that the same approach is adopted for transaction costs disclosure in the context of workplace Defined Contribution (DC) pensions as well.

2 Performance Scenarios

2.1 Under the FCA Handbook and various European rules (including the PRIIPs Regulation), European asset managers and PRIIPs manufacturers / providers are required to ensure their communications with investors are fair, clear and not misleading (where relevant, by taking into account the status of the client as a retail investor). However, in our members' experience, the PRIIPs performance scenarios risk giving a misleading and distorted impression to investors of future fund performance, contrary to this important principle of UK and European law.

2.2 Our key concern with the PRIIPs performance scenario methodology is that it uses past performance data as the primary basis to predict future performance, and therefore ends up projecting the fund's historic 5 year performance (good or bad) into the performance forecasts set out in the KID. As noted by the industry, and the FCA in the Call for Input and on its website earlier this year, due to high market returns over the last few years the PRIIPs performance scenarios for many funds currently predict a positive return / growth outcome

for retail investors, even in the stressed and unfavourable performance scenarios – thereby promising the same historic market highs / returns for the future.

2.3 The methodology also adopts this approach notwithstanding the recommended holding period for the fund. While using performance data from the past 5 years that presents a very positive investment outlook could be justified for a 1 - 2 year forecast period, the outcomes start looking very misleading for PRIIPs products that are recommended or expected to be held for a must longer duration, as this positive performance and favourable market conditions are unlikely to subsist over 10 – 15 years.

2.4 In our view, investors would benefit from seeing the past performance information itself (which is a much more reliable indicator of the fund's track record in terms of performance) alongside appropriate disclaimers and warnings (as required by the FCA and UCITS rules currently) that manage investor expectations by alerting them to the fact that past performance is not a guarantee of future results. We think such an approach will much better guide investor expectations on return (i.e. seeing past performance as a track record with appropriate warnings) rather than a methodology that effectively presents and promises past performance as future performance.

2.5 We would therefore recommend that performance scenarios are dropped from the KID and replaced instead with past performance data (accompanied with appropriate warnings and disclaimers) as is the case with current UCITS KIIDs. Or at the very least that firms are able to provide past performance data within or alongside the KID to allow them to better guide and manage investor expectations on return.

3 Extending the Article 32 exemption for UCITS and non-UCITS retail funds

3.1 UCITS funds and non-UCITS retail funds that are required to prepare KIIDs under local rules, are currently exempt from the requirement to prepare a PRIIPs KID until 31 December 2019. We would strongly recommend that this exemption is extended until current issues and defects within the PRIIPs rules have been resolved.

3.2 Given the misleading performance outcomes and costs disclosures the PRIIPs requirements are currently generating in the non-UCITS space, we think this would be the most favourable outcome from an investor disclosure perspective (who are also very familiar and comfortable with the current UCITS KIIDs) noting also the much wider retail base of these funds.

3.3 We also think this would be the best outcome for the industry as it would avoid UCITS / in-scope non-UCITS retail funds expending costs and resources to implement the PRIIPs KID regime twice (i.e. when the exemption expires and subsequently when the revisions to the overall PRIIPs regime are effected).

Conclusion

The AMG supports the FCA's efforts to obtain industry feedback on their experienced with the PRIIPs Regulation and stand ready to provide any additional assistance that the FCA might find useful. Please do not hesitate to contact either Tim Cameron at tcameron@sifma.org or Lindsey Keljo at lkeljo@sifma.org if you have any comments or questions regarding this letter.

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