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Research Update: July 2014

PRIIPs, Ongoing Charges & Soft Commissions

Background

The OCF rather than the AMC is likely to become the primary measure of charges in investment products disclosure as a result of PRIIPs regulation. In this research update, George McCutcheon discusses PRIIPs, ongoing charges for funds and regulatory developments on the use of dealing commissions.

Key Messages for Insurance Companies

- Life companies should prepare for the use of the ongoing charges figure (OCF) rather than the annual management charge (AMC) in product disclosure as PRIIPs[1] regulation is likely to result in OCFs replacing AMCs as the measure of charges.
- Regulatory rule changes for the use of dealing commissions are likely. The FCA has announced its support for proposed European reforms to further separate research from dealing commission to encourage greater competition and more transparency over the price of research.
- Insurance companies should ensure that they are aware of FCA Policy Statement PS14/7[2] (in the context of asset management whether in-house or outsourced and also investment in collective investment undertakings) and also of the wider debate on the use of dealing commissions.

Background

The life industry has historically used the AMC concept to mean the annual fee levied by the life company for managing a fund. The concern is that customers might misunderstand this to represent the total costs incurred in managing the fund whereas in practice other costs are charged to the fund. In contrast the funds industry since July 2012 (in accordance with the UCITS IV Directive) has used the OCF in the Key Investor Information Document (KIID)[3] as the measure for the charges levied for managing a fund.

PRIIPs regulation will result in standardisation of charge measures. The requirements of the PRIIPs Regulation will apply from about mid-2016 (two years after it enters into force). Some UK life companies already show both AMCs and OCFs in fund factsheets. The OCF provides a common standard for all the known costs and charges that a fund will bear in a single comprehensive ratio that is easy to understand and to compare. However not all charges are reflected in the OCF and there is currently a wider debate about the need for a new measure to reflect all charges.

Dealing commissions are a relevant issue firstly because they are excluded from the OCF and secondly because FCA supervisory work has identified issues of concern on the use of dealing commissions.

PRIIPs Regulation

The regulation on key information documents (KID) for packaged retail and insurance based investment products, otherwise known as the PRIIPs Regulation is a key component of new European legislation to protect investors.

The PRIIPs regulation will apply on a cross industry basis (asset management, banking and insurance) and will change the way information is provided to investors at the point of sale.

A key part of PRIIPs regulation is that the KID has to include information on the costs associated with an investment in the investment product, comprising both direct and indirect costs to be borne by the investor, including summary indicators of these costs. The proposal for the PRIIPS regulation includes that the three Level 3 Committees of national supervisors (EBA, EIOPA and ESMA)[4] draft regulatory standards to determine the calculation of costs.

The UCITS IV Directive prescribed that the KIID had to include information on costs and associated charges and that the Commission would adopt implementing measures to define the detailed content. The Committee of European Securities Regulators (CESR- the committee preceding ESMA) was tasked with this with the resultant CESR/10-674 using ongoing

[1] Packaged Retail Investment and Insurance based Investment Products

[2] " Changes to the use of dealing commission rules" issued by the FCA in May 2014

[3] The KIID is a two-page document that provides detail about the fund's objective and investment policy, risk and reward, charges and past performance.

[4] European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA)

charges figure as the charge measure.
Whilst the draft PRIIPs regulatory technical standards will take into account the different types of investment products, given this UCITS IV Directive precedent it is likely that the OCF will be the charge measure for the KID under PRIIPs regulation.

FCA Thematic Review 14/7 "Clarity of fund charges"
The FC carried out a thematic review published in May 2014.

Thematic review to understand how firms discharge their responsibilities as agents in ensuring charges are clear to investors

Its assessment was based on existing rules that firms should appropriately represent the interests of investors, manage conflicts of interest between the firm and investors and ensure that communications are clear, fair and not misleading.
There were two main messages from the review.
1. Using the annual management charge (AMC) in some marketing material and the ongoing charges figure (OCF) in other documents may confuse investors and hinder their ability to compare charges.
2. Using the OCF consistently in all marketing material for UCITS funds is likely to help investors understand and compare charges.

Current Developments
The Investment Management Association (IMA) has called on all market participants, fund managers, platforms, IFAs, data providers and the media to respond to the FCA's proposals by abandoning all use of AMCs and by the exclusive use of the OCF in marketing literature, advice and commentary.
The IMA is proposing a new measure of telling investors how much it has cost them (in pounds and pence per unit) to own units in a fund each year. This is a radical approach which goes beyond any disclosure required by regulators. The new measure covers all payments by the fund. It includes both the manager's fees and all other operational costs and also includes all the dealing costs and stamp duty paid when an investment manager buys and sells holdings in the fund's portfolio. The IMA hopes that the FCA will incorporate the proposals into its regulations. The IMA's proposals were formally ratified by the Financial Reporting Council (FRC).

Next step for IMA will be develop a common standard for the calculation of "Portfolio Turnover Rate"

The "Portfolio Turnover Rate" is a measure that reports how actively the investment manager buys, sells and holds shares. This is because trading has implicit costs such as the "spread" between buying and selling prices.

Definition of OCF
The ongoing charges figure[5] is the ratio of the 'ongoing charges' to the average net assets of the fund.
'Ongoing charges' are payments deducted from the assets of a UCITS where such deductions are required or permitted by national law and regulation, the fund rules or instrument of incorporation of the UCITS, or its prospectus but excluding specified exceptions.
The main exceptions are entry/exit charges; performance fees; acquisition/disposal costs such as commission, stamp duties, taxes; and interest on borrowings. However acquisition/disposal costs in respect of an underlying Collective Investment Undertaking (CIU) have to be taken into account.
Thus broadly speaking, ongoing charges are the costs that the fund would incur in the absence of any purchases or sales of investments and if markets remained static through the period.
Ongoing charges are different to total expenses as not all expenses are considered to be operational and recurring.

[5] expressed as a percentage to two decimal places

Calculation of OCF

CESR has provided guidelines on the calculation of the OCF viz CESR/10-674 (CESR's guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document).

Although the OCF based on historical information, it provides customers with an indication of the likely level of charges levied in managing the fund.

Examples of Ongoing Charges

'Ongoing charges' include:

- Payments to the management company of the UCITS, directors of the UCITS if an investment company, the depository, the custodians, investment advisors;
- Payments to any person providing outsourced services e.g. providers of valuation and fund accounting services, shareholder service providers, such as the transfer agent and broker dealers that are record owners of the UCITS' shares and provide sub-accounting services to the beneficial owners of those shares;
- Registration fees, regulatory fees and similar charges;
- Audit fees;
- Payments to legal and professional advisers;
- Costs of distribution.

Where a UCITS invests a substantial proportion of its assets in other UCITS or CIUs, and so makes the disclosures required by the second paragraph of Article 50(3) of the UCITS Directive, its ongoing charges figure has to take account of the ongoing charges incurred in the underlying CIUs.

Excluded 'Ongoing charges' include

(a) Entry / exit charges or commissions, or any other amount paid directly by the investor or deducted from a payment received from or due to the investor;

(b) Performance-related fees

(c) Interest on borrowing;

(d) Payments to third parties to meet costs necessarily incurred in connection with the acquisition or disposal of any asset for the UCITS' portfolio, whether those costs are explicit (e.g. brokerage charges, taxes and linked charges) or implicit (e.g. costs of dealing in fixed interest securities, market impact costs);

(e) Payments incurred for the holding of financial derivative instruments (e.g. margin calls);

(f) The value of goods or services received by the management company or any connected person in exchange for placing of dealing orders (soft commissions or any similar arrangement).

PS 14/7 "Changes to the use of dealing commission rules" issued by the FCA

Issued in May 2014, the proposals clarify existing expectations under the FCA rules rather than create new requirements. Thematic supervisory work had concluded that the majority of investment managers had inadequate controls and oversight when acquiring research goods and services from brokers or other third parties in return for client dealing commissions. They were unable to demonstrate how items of research met the exemption under FCA rules and were in the best interests of their customers.

The finalised changes in the PS support the FCA's operational objectives of enhancing consumer protection and market integrity by ensuring dealing commissions are only used to acquire eligible goods and services, and that these costs are subject to proper controls by investment managers in line with the original policy intention. This should ensure the use of commissions is interpreted correctly as a narrow exemption allowing the investment manager to pass on only a limited range of costs – those directly related to execution of trades or the provision of substantive research – to their customers' funds.

COBS 11.6.3 as amended with effect from 2 June 2014 effectively prescribes that subject to some exceptions that an investment manager cannot accept any good or service (in addition to the execution of its customer orders) offered in return for charges passed on to the investment manager's customers through dealing commissions.

The exceptions are where that good or service is either directly related to the execution of trades or amounts to the provision of substantive research and where the investment manager's receipt of that good or service is not likely to, impair compliance with the duty of the investment manager to act in the best interests of its customers; and where the investment manager has reasonable grounds to be satisfied that the good or service will reasonably assist the investment manager in the provision of its services to its customers. All three conditions must be satisfied.

The relevance of dealing commission rules in this research update is that soft commissions are excluded from the calculation of the OCF whereas unbundled research paid for directly would be included as ongoing charges.

A Wider Debate

Following the FCA Asset Management Conference in October 2013, the FCA have been engaging widely with stakeholders in an open debate to consider whether the use of dealing commission regime is fit for purpose in the longer term. The debate has been framed in the context of ongoing EU negotiations to revise MiFID, because MiFID II has the potential to impact the ability of portfolio managers to receive third party inducements, which may include research acquired in return for dealing commissions linked to execution services.

On 10 July 2014, the FCA published a review of how firms use dealing commission - the charges paid by consumers for executing trades and external research, worth around £3 billion a year. It found too few firms properly assess the value-added and cost of research paid for using client dealing commission. The review also found that the practice of brokers bundling execution and research services makes it harder for investment managers to assess the value of research. Based on these findings, the FCA has announced its support for proposed European reforms.

Proposed European reforms to further separate research from dealing commission, to encourage greater competition and more transparency over the price of research.

Following consultation in November 2013, the FCA clarified its rules on dealing commission in May 2014 to make it explicitly clear that firms should only be paying for services directly related to executing a trade or substantive research out of dealing commission.
This review of 17 investment managers and 13 brokers found only two investment managers operating at the level expected. The FCA are in active discussion with one firm on redress for clients because the firm used dealing commission to pay for market data services in full, despite clear statements that this was not consistent with FCA rules.

Speaking at a recent FCA conference on dealing commission, FCA chief executive Martin Wheatley said:
“There is strong evidence to suggest the current model of using dealing commission to pay for research reduces transparency and creates a link between research spend and trading volume, without a clear assessment of the value this offers to investors.”

If you would like to discuss any of the issues in the note, please contact George at George.McCutcheon@frsltd.com or on 003531 2340005.

Biography; George McCutcheon MSc FIA:
Mr. McCutcheon is a graduate of University College Dublin in Mathematical Science and is a Fellow of the Institute of Actuaries. He is a director and co-founder of Financial Risk Solutions (FRS). He has presented a number of papers at the Life Convention of the Institute of Actuaries and has written a number of papers for the Society of Actuaries in Ireland.

About Financial Risk Solutions (FRS)
Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing and fund administration software to the life assurance and pensions industries. Its Invest|Pro™ product family is a recognised leading benchmark in the investment fund administration area and customers include some of the biggest brands in life assurance and third party administration including MetLife, SEB, IFDS Percana, and Accenture Managed Services.

FRS's mainline product Invest|Pro™ manages unit pricing and portfolio valuations, asset/liability unit matching, box management, trade order management, investment accounting, financial reporting and compliance with investment mandates in a single application. Product types covered include unit linked funds, portfolio bonds, self-invested/directed pensions, shareholder funds and with-profit funds. Invest|Pro™ was specifically designed to securely automate complex fund administration processes.

FRS's product Invest|Comp™ provides visibility of aggregate asset positions and other relevant compliance and risk management data. Invest|Comp™'s Data|Pump server application is used to populate and synchronise the Invest|Comp™ data warehouse with data from the company's investment systems and from external market data providers.

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