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ASSET MANAGEMENT COSTS AND CHARGES

Are the FCA and the EU singing from the same hymn sheet?

Asset managers will be hit by a wave of new regulation when MiFID II applies from 3 January 2018, including new requirements on the disclosure of costs and charges. Compounding the complexity, the FCA's interim report on its Asset Management Market Study suggests remedies for the transparency of fund charges which would go further than MiFID.

On 27 March 2017, the Investment Association published a consultation on a new code for enhanced disclosure of charges and transaction costs, which takes account of MiFID II, the PRIIPs Regulation (Regulation 1286/2014) and the FCA's consultation on draft rules for transaction cost disclosure to workplace defined contribution (DC) pension schemes. However, it notes that the final document will need to take into account the ultimate findings of the FCA Asset Management Market Study.

In this article, we consider the FCA's direction of travel on transparency for costs and charges in light of the MiFID II requirements and how we may arrive at a consistent framework.

Costs and charges disclosure: what's new under MiFID II?

The application of the costs and charges disclosure requirement under MiFID I by firms has been inconsistent due to certain ambiguities in the drafting. MiFID II clarifies existing provisions relating to costs and charges disclosures and introduces additional requirements. MiFID II states that the information to be provided on all costs and associated charges relating to MiFID services must include:

"Information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing third party payments"

MiFID II further states[1]:

"The information about all costs and charges, including costs and charges in connection with the investment service and the financial instrument, which are not caused by the occurrence of underlying market risk, shall be aggregated to allow the client to understand the overall cost as well as the cumulative effect on return of the investment, and where the client so requests, an itemised breakdown shall be provided. Where applicable, such information shall be provided to the client on a regular basis, at least annually, during the life of the investment."

MiFID II requires costs information to be "provided in a comprehensible form", which Member States can allow to be in a standardised format. The FCA has decided not to take a standardised approach to the presentation of MiFID II costs and charges, despite many firms wanting it to do so.

MiFID II: Delegated Regulation

The European Commission adopted a Delegated Regulation on 25 April 2016 based on ESMA's technical advice which, inter alia, addresses costs and charges disclosure, summarised below.

Scope- retail clients, professional clients and eligible counterparties

- Costs and charges information should be made available to retail clients, professional clients and eligible counterparties (the current requirements only apply to retail clients). Firms can agree a limited application with: a professional client, unless: (i) the service includes investment advice or portfolio management; or (ii) the financial instruments concerned embed a derivative (regardless of the service being provided); or an eligible counterparty, unless: (i) the financial instruments concerned embed a derivative; and (ii) the eligible counterparty intends to offer them to its clients.

Scope- point of sale disclosure

- The obligation to provide a full before sale disclosure (relating to the service provided and the underlying financial instrument) applies to a firm when it: (i) recommends or markets financial instruments to clients (to be interpreted broadly and to include firms providing advisory or portfolio management services, general recommendations concerning financial instruments, or promoting instruments when providing services); or (ii) is required to provide a KID/KIID in relation to the relevant financial product, in accordance with PRIIPs/UCITS.[2]

[1] Article 24 MiFID II

[2] Persons advising on or selling Undertakings for Collective Investment in Transferable Securities (UCITS) (whether directly or under a distribution arrangement) are required to provide retail and professional investors with a Key Investor Information Document (KIID) drawn up by the UCITS or its management company. From January 2018, persons advising on or selling Packed Retail Investment Products and Insurance-Based Investment Products (PRIIPs) will be required to provide retail investors (not professionals) with a Key Investor Document (KID) drawn up by PRIIPs manufacturers.

- In all other cases, where investment firms have not marketed or recommended a financial instrument or are not required to provide clients with information about costs of a financial instrument (e.g. under PRIIPS/UCITS), they may not be in the position to take into account all the costs associated with that financial instrument. Even in these few instances, firms should inform clients, before sale, about all costs and charges associated to the investment service and the price of acquiring the relevant financial instrument.
- If more than one firm provides investment and/or ancillary services to the client, each firm must provide information about its own costs. If a firm recommends or markets the services provided by (or directs clients to) another firm, it should aggregate the costs of its services together with the cost of the services provided by the other firm.

Scope- post-sale disclosure

- Annual post-sale information on costs and charges related to both the financial instrument and investment and/or ancillary service should be provided by firms caught by the disclosure requirements where there is an ongoing client relationship during the year. Firms that provide a 'one-off' service (such as a one-off order execution) are not therefore caught. Post-sale costs disclosure can be made within existing periodic reporting and should be provided on a personalised basis.

Costs to be disclosed to clients

- Annex II of the Delegated Regulation sets out a list of costs and charges to be disclosed to clients, separating out costs and charges related to: (i) the investment service(s) and/or ancillary services; and (ii) the financial instrument. Items to be disclosed include: one-off charges, on-going charges, transactions costs, charges related to ancillary services and incidental costs.

- Examples of the fees which fall under each item are provided in Annex II to the Delegated Regulation. Certain cost items appear in both tables but are not intended to be duplicative since they refer respectively to costs of the product and costs of the service.

COST ITEM TO BE DISCLOSED	INVESTMENT SERVICE(S) AND/OR ANCILLARY SERVICES	FINANCIAL INSTRUMENT
One-off charges	Deposit fees, termination fees and switching costs	Front-loaded management fee, structuring fee, distribution fee
On-going charges	Management fees, advisory fees, custodian fees	Management fees, service costs, swap fees, securities lending costs and taxes, financing costs
All costs related to transactions	Broker commissions, entry and exit charges paid to the fund manager, platform fees, mark ups (embedded in the transaction price), stamp duty, transactions tax and foreign exchange costs	Broker commissions, entry and exit charges paid by the fund, mark ups embedded in the transaction price, stamp duty, transactions tax and foreign exchange costs
Any charges related to ancillary services	Research costs, custody costs	Not applicable
Incidental costs	Performance fees	Performance fees

- Firms are allowed to provide separate figures comprising aggregated: (i) initial costs and charges; (ii) on-going costs and charges; and (iii) exit costs.

- Third party payments received by the firm in connection with the investment service shall be regarded as part of the cost of the service to the client and identified separately (i.e. it needs to be clear to the client what part of the costs paid are rebated to the firm providing the investment service).

- Where any part of the costs and charges is to be paid in or represents an amount of foreign currency, firms must provide an indication of the currency involved and the currency conversion rates and costs.

- Where ex-ante cost figures are given (i.e. costs based on forecasts of, for example, fees based on a percentage of AUM), firms should use actually incurred costs as a proxy for expected costs (presumably based on past client records), and where actual costs are not available, a reasonable estimate of costs should be given. Ex-ante assumptions should be reviewed by the firm based on results from actual experience and adjustments to assumptions should be made if necessary. Firms will need to disclose that estimations are based on assumptions and may deviate from costs and charges that will actually be incurred. The FCA has said that it may issue guidance on forward-looking costs in the future.

- Firms should use actually incurred costs as a proxy for the expected costs and charges; and before sale information can be provided based on an assumed investment amount. However, the costs and charges disclosed should represent the costs the client would actually incur based on that assumed investment amount. And for ex-post disclosures, information related to costs and charges should reflect the client's actual investment amount at the time the disclosure is produced.

- ESMA recognises in its technical advice some practical difficulties in quantifying some charges:

  - Transaction costs (described as all costs incurred in order to acquire and dispose of investments) - in some markets (for example, bond, derivatives and foreign exchange markets) transaction costs are embedded in the bid-ask spread of the financial instrument and are difficult to quantify (see below);

  - Assets under management - many managers apply a fee based on a percentage of a client's AUM, which presents difficulties in calculating the cost of ongoing charges at product level as this depends on the value of assets. Firms should make estimations based on reasonable assumptions.

Aggregation

- As mentioned above, firms must aggregate all costs and charges: (i) charged by the firm (or other parties where the client has been directed to such other parties) and/or ancillary services provided to the client; and (ii) associated with the manufacturing and managing of the financial instruments. The aggregated costs and charges should be totalled and expressed both as a cash amount and as a percentage.

- A firm must provide aggregated information about all costs and charges to clients / potential clients in 'good time' before the provision of the service or financial instrument. The exceptions for transactions concluded by means of certain distance communications or use of voice telephony no longer exist.

Cumulative effect of costs on the return

- Firms must provide an illustration showing the cumulative effect of costs on return of the investment. The illustration must: (i) show the effect of the overall costs on return; (ii) show anticipated spikes or fluctuations in costs; and (iii) be accompanied by an explanation of what the illustration shows.

Asset Management Market Study

The FCA launched its asset management market study in November 2015 following concerns that came to light during its wholesale sector competition review. The purpose of the study was to understand how competition between asset managers works and whether the FCA should introduce measures to remedy any identified failings. In November 2016, the FCA published an interim report of its findings in which it stated that the evidence suggests that there is weak price competition in a number of areas of the industry which has a material impact on the investment returns of investors.

The FCA has proposed some remedies to address the concerns relating to transparency of costs and charges, including disclosure of an "all-in-fee" and proposals on clearer communication of fund charges and their impact at the point of sale and in ongoing communication to retail investors.

All-in fee approach to quoting charges

Although there is a strong industry view that the current ongoing charges figure (OCF), which managers of UCITS funds must disclose to investors, is a meaningful figure representing fund charges, the FCA does not consider that it represents the full cost of investing. In particular, the FCA is concerned that transaction costs (stamp duty, dealing commissions paid to stockbrokers and the 'bid-offer spread') are not disclosed to investors before they make their investment decisions, as well as 'one-off' fees, such as entry and exit charges or performance fees. The FCA also notes that charges are estimated in advance, meaning investors bear the risk of actual charges being different from the estimates, when they have no ability to control such differences.

The requirements proposed by the FCA in its interim asset management market study report go beyond the MiFID II costs and charges disclosure requirements and, if taken forward, are likely to have a significant impact on asset managers' MiFID II implementation plans, which are already presenting a number of challenges for firms.

In the FCA's view, poor transparency is likely to contribute to limited price competition for actively managed funds and asset managers being less effective at controlling complex costs. To address these concerns, the FCA has proposed the introduction of an **all-in-fee** approach to quoting charges, so that investors in funds can easily see what is being taken from the fund and impose more discipline on overspend relative to charging estimates.

The FCA suggests four possible ways in which the all-in fee could be implemented. These are explored in the table below, together with a consideration of how each option, if taken forward, would fit with the MiFID II costs and charges disclosure requirements.

Transaction charges

One of the most controversial areas which remains, as yet, unresolved, is what is meant by transaction costs, in particular, implicit costs. Annex II to the Delegated Regulation provides that transaction costs are: "all costs related to transactions initiated in the course of the provision of an investment service, for example, broker commissions, entry and exit charges paid to the fund manager, platform fees, mark ups (embedded in the transaction price), stamp duty, transactions tax and foreign exchange costs". The FCA states that transaction costs can be "explicit or implicit ... Implicit costs are not directly billed to the client, but are recognised by market participants and are real costs (for example, the bid-offer spread and market impact)".

The Investment Association has expressed concern regarding any methodology showing costs to be the difference between a benchmark price and the execution price achieved because in its view "what is reported as 'costs' are essentially the impact of price movements which can be excessively large in nature (large enough even to outweigh the management fee) and negative (if the market price moves in the trader's favour). This is likely to be very challenging for clients to interpret when trying to assess costs in the context of value for money". The Investment Association's preferred baseline reporting approach is to calculate implicit costs based on the market spread.

How do the FCA options for cost's transparency fit with MiFID II costs disclosure requirements?

FCA OPTIONS FOR COST'S TRANSPARENCY	EXPLANATION	HOW DOES THIS FIT WITH MiFID II REQUIREMENTS?
The current OCF becomes the actual charge that is taken from the fund.	The asset manager's balance sheet would cover any variation between the estimated OCF and actual ongoing charges taken from the fund. The OCF does not include transaction costs (stamp duty, dealing commissions paid to stockbrokers and the 'bid-offer spread') etc. so these would not be included in the estimated OCF nor the variation with the actual ongoing charges for which the asset manager would be liable. This option would require the least change from the current way of deducting charges.	Requiring asset managers to cover the variation between the estimated and actual OCF goes beyond MiFID II requirements to the extent that the latter are merely focused on increased transparency of charges as opposed to increased liability for costs to be borne by the asset manager. However, under this proposed option, the estimate for which firms are liable for overspend does not include transaction costs and other charges not currently in the OCF. Under MiFID II, firms would have to disclose transaction and other costs and charges not currently required in the OCF within the aggregated costs and charges figure. If the FCA took forward this proposal, it would therefore need to consider how to ensure disclosures are made clear to clients in order to avoid confusion, as this option would result in disclosure of both: (i) an estimated OCF not including transaction and other similar costs (not currently required to form part of the estimated OCF) with the firm liable for any overspend in respect of that figure; and (ii) an aggregated MiFID II costs and charges figure, which includes everything in the OCF as well as other transaction cost and charges items. The disclosure of these various figures for the purpose of the MiFID II requirements and FCA super-equivalent rules might also represent an administrative burden on firms.

The current OCF becomes the actual charge, with managers providing an estimate of any implicit and explicit transaction costs.	Similar to the above, but obliges asset managers to estimate transaction costs, to enable easier customer comparison of the likely total charges across different funds.	This is similar to the above option, however there is an obligation to estimate implicit and explicit transaction costs. As transaction costs need to be included in the aggregated MiFID II costs figure, this option would be consistent with MiFID II. The only practical difference would be that the FCA may require the estimated transaction costs to be set out separately (i.e. as well as within the aggregated figure under MiFID II).
There is a single charge which includes all charges taken from the fund, including both implicit and explicit transaction costs, but with an option for 'overspend'.	The single charge covers all costs, but to compensate asset managers for trades in exceptional circumstances, managers would have discretion to take additional transaction charges from the fund, which would be clearly explained to investors in the annual statement.	As above, this goes beyond the MiFID II requirements in that it requires asset managers to cover the variation between the single disclosed charge and actual ongoing charges. The single charge includes all charges taken from the fund, including transaction costs. The FCA noted that this could result in managers trading less than would be optimal for investors. Hence the FCA is considering allowing asset managers to charge for "overspend" in exceptional circumstances. In either case, the inclusion of transaction costs in an all-in-fee would increase fixed charges, making funds likely seem more expensive than at present.
There is a single charge which includes all charges taken from the fund, with no option for overspend.	This option would bind the manager to the single charge figure, who would have to pay any additional investment-related or administrative expenses (including transaction costs). The manager would therefore bear all the risk of a difference between forecast and actual trading costs.	This is the most draconian of all of the options for an all-in-fee proposed by the FCA. The issues are the same as the above option, but this option will be more concerning for firms as there is no allowance for overspend, even to allow for trading in exceptional circumstances. It would be the option most likely to result in increased headline charges for funds.

The proposal for an all-in-fee could therefore result in a gold-plating of the MiFID II costs and charges requirements, which are already presenting a number of challenges for asset managers. The MiFID II requirements are already extensive and appear to address the concerns raised by the FCA, although clearly, they do not go as far as to transferring risk of unexpected expenditure to the fund manager.

The FCA notes in its interim report that its overall policy package will take account of MiFID II. It may be that feedback from the industry will persuade the FCA that the MiFID II (and PRIIPs) rules are sufficient to address the concerns around costs and charges disclosure and there is no immediate need for it to introduce super-equivalent rules in this area. However, even after the MiFID II reforms, investors still ultimately bear the risk of actual charges being different from estimates and to address this concern, the FCA may press on with its proposals for an all-in-fee, with asset managers covering any variation between estimates and actual costs.

The FCA does recognise that passing overspend risk to the fund manager may result in an increase in charges to the investor or the manager trading less than is in the interests of investors. It is therefore seeking feedback on the extent to which competition will provide enough pressure to address its concerns.

Clearer communication of fund charges and their impact on retail investors

The FCA also wants to introduce remedies to proactively encourage investors to focus on the impact that charges have on their investments and enable price comparison. The options it is seeking feedback on are:

- Making greater use of pounds and pence charging figures in 'point of sale' documentation. The OCF is currently presented as an estimated percentage of total AUM. The FCA finds that investors are better able to understand charges when presented in cash amounts. PRIIPs and MiFID II will address this issue by requiring the charges figure to be a cash amount as well as a percentage, but the FCA is concerned as studies show that only 25% of non-advised investors reported looking at the KIID when choosing a fund. The FCA therefore considers that there is scope for other information sources to make use of monetary figures (such as fund managers' literature and information from advisers and platforms), which would go beyond PRIIPs and MiFID II which will require cash amounts to be given in costs disclosure documents as opposed to miscellaneous marketing material.

- Illustrating the impact of charges in 'ongoing' communication documents. The FCA considers that there is scope for fund managers to explain more clearly the impact charges have had on gross returns so that investors know how much they are paying for their investments on an ongoing basis, and to disclose the total cost of investment (including distribution) pre-sale and on an ongoing-basis. Whilst the exact nature of the FCA proposal is not clear, MiFID II appears to introduce similar requirements- for example, an obligation to provide aggregated costs at the point of sale (presumably this is the same as providing information on the total cost of their investments) and also post-sale on an annual basis where there is an ongoing client relationship. There is also the requirement to disclose the cumulative effect of costs on the investment return, which again, seems to address the FCA's point in relation to explaining the impact charges have on gross returns.

How do MiFID II disclosure requirements interact with UCITS/PRIIPs requirements?

- Where additional MiFID investment services are provided by a UCITS manager, or where a firm distributes units in a UCITS scheme or PRIIPs, the firm must take care to inform clients about any costs and charges related to the product which are required under MiFID II (e.g. relating to the investment services) but may not have been included in the KID or KIID. Importantly, there is certain information not required to be included in the UCITS KIID, which is required to be disclosed under MiFID II (quantitative information on transaction costs, and a cash as well as percentage figure for costs).

- The PRIIPs KID requirements are closely aligned to MiFID II requirements, but firms should still take care to ensure that they are meeting their obligations under both MiFID II and PRIIPS where relevant. Firms distributing PRIIPs to professionals or eligible counterparties must also make sure that the MiFID II disclosure requirements are met (PRIIPs only requires a KID to be provided to retail investors).

- Firms subject to UCITS will be exempt from PRIIPs KID requirements for a transitional period, and during this period information which is not required to be included in the KIID but is required to be disclosed under MiFID II should be separately disclosed by firms.

What next?

The FCA may choose to adopt a "wait-and-see" approach and revisit this area again once MiFID II is in force to see if the new requirements have addressed its concerns and improved investor outcomes.

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