



Costs and charges: regulators move into top gear

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Driven by political, regulator, investor and media attention, costs and charges now sit squarely at the top of the reform agenda in the investment and fund management industry. If there was any doubt about the importance of the issue, recent moves by IOSCO and ESMA have removed it.

Within **Europe**, the implementation of MiFID II will bring about fundamental changes to industry commission practices, and a number of other countries, too, have introduced new rules in this area.

A number of regulators continue to scrutinize the level of charges and their disclosure. “Closet tracking” remains under the spotlight and the UK, for example, is applying more intensive scrutiny to the level of charges for “active” fund management.

Disclosure of the remuneration of senior management and portfolio managers continues to attract regulatory attention.



IOSCO guidance likely to be seen as cast in stone

IOSCO's Investment Management Committee in August 2016 provided good-practice guidance for fees and expenses of collective investment schemes (CIS). The guidance is not intended to form comprehensive requirements or to impose obligations on national regulators, but both regulators and firms increasingly regard IOSCO's output as setting the "pass" mark for good operational behavior.

The guidance covers regulated open-ended funds, and closed-ended funds whose shares are traded on a regulated market, and both fees paid directly by investors to the CIS operator or its agent or associate, and fees or expenses paid out of fund assets.

IOSCO describes the latter as falling into four broad categories:

1. Remuneration of the manager, including the method of calculation of performance fees
2. Distribution costs
3. Other fund operating expenses, such as custody, fund accounting or administration costs
4. Transaction costs associated with purchases and sales of portfolio assets, including securities lending and repo and reverse repo transactions.

The report makes no observations on regulatory or other expenses that may be paid out of fund assets.

Many of the good practices focus on disclosure to investors. Information should be disclosed to both prospective and current investors in a way that allows them to make informed decisions about whether they wish to invest in a CIS and accept the costs of doing so.

The report includes a section on the calculation and disclosure of transaction costs. IOSCO notes the industry consensus that explicit transaction costs should be determined accurately after the

transaction. There is less agreement on whether implicit costs can be measured retrospectively. Estimating transaction costs in advance is even more prone to variation. There is a risk that predictions of costs could turn out to be so inaccurate as to be misleading, and even illegal in some jurisdictions.

These statements are in sharp contrast to the EU's rules for the PRIIP KID on the calculation of future transaction costs for funds.

Efficiency and transparency – ESMA sets the tone

ESMA has signaled it is ready to act. It believes more can be done to improve the efficiency and transparency of the investment fund sector and is working to improve the information available to investors.

ESMA Chair, Steven Maijor, speaking in November 2016 at EFAMA's Investment Management Forum, highlighted that ESMA is committed to building on regulatory and technology initiatives to achieve better outcomes for investors.

ESMA says improving the information available to investors will help them choose funds that offer them value for money. MiFID II requires information about third-party payments to be provided to clients. This would show investors what they indirectly pay for the services they receive, allow them to understand the total costs and be able to compare between different services and financial instruments. Additionally, ESMA believes a stronger focus on cost disclosure and inducements should lead to more competition among service providers and, potentially, reduce fees.

This focus on costs and charges builds on a speech earlier in the year by Mr. Maijor. In June 2016, he said fund managers should bring down charges on retail funds to align them more closely with fees levied on institutional investors.

“... retail investors are not enjoying the lower fees charged to professional clients for similar products.”

According to Fitz Partners, a research firm specializing in fund charges, the divergence of fees charged to retail and institutional investors is seen in both active-managed and index-tracking products. For instance, the average ongoing charge for an institutional cross-border equity fund is 0.98 percent, compared with 1.92 percent for the retail share class. Similarly, a retail investor purchasing an index tracker will pay an average 0.43 percent, compared with just 0.27 percent for institutional clients.

Mr. Maijoor said that despite “big demand” for cheaper investment products, European retail investors are not enjoying the lower fees charged to professional clients for similar products. “We know that the costs of asset management products in Europe on average are higher than in the US,” he said. “Some of that relates to scale.”

The European Commission has signaled it is ready to back ESMA. In February 2017, it launched a study of European fund fees and investment performance. Sven Gentner, head of the Commission’s Asset Management Unit, said it is “keen to advance the policy agenda” on fees. The study’s findings, which will be published by the end of 2017, will “inform policy decisions,” he said. European investors should be able to compare investment products easily but there is evidence “this is not the case.”

Payments to distributors – a global issue

In Europe, MiFID II bans commissions paid to independent financial advisors and wealth managers, while payments to other parties must pass a “quality enhancement” test of the service received by the client. However, as we noted last year, implementation is likely to be patchy at first. Indeed, we see differences in approaches already.

In **Sweden** and **Denmark**, for instance, the regulators considered a wider ban on inducements paid to advisors to retail clients, which would have stopped banks from accepting payments from third-party investment managers. This would go further than MiFID II by extending the prohibition against accepting benefits from third parties to cover all advisory services, regardless of whether they are independent, as is already the case in the **UK** and the **Netherlands**. However, neither Sweden nor Denmark proceeded with a fuller ban.

The long lead-time (seven years and counting) for the creation and implementing of MiFID II has given regulators elsewhere plenty of time to consider the implications for their own jurisdictions. In many cases, they have decided on a similar path, albeit with slightly different approaches.

In **Switzerland**, the Swiss Financial Services Act – which will come into force in 2018 at the earliest – includes rules on suitability and appropriateness when providing investment advice or portfolio management, information, documentation, accountability, transparency and due diligence for client orders.

In **Japan**, draft “Principles for Customer-Oriented Business Conduct” were published by the Working Group on Financial Markets in December 2016. The principles were conceived after it was discovered that fund managers and distribution agents colluded to hide excess returns from a fund-based insurance product. As a result, many ordinary investors – many of them elderly – were deprived of their rightful returns.

The seven principles are:

1. Formulate and publish policy on customer-oriented investment management and intermediation
2. Pursue the best interest of customers
3. Appropriately manage conflicts of interests
4. Clarify commission fees
5. Provide easily-understandable key information
6. Provide services that are suitable for the specific customer
7. Design an appropriate motivation framework for employees

As in **Germany**, where similar regulation was enacted a decade ago, the impact on Swiss investment management is likely to be considerable. In Germany, the number of managers shrank to 10 percent of the original due to consolidation.

The rules may impact foreign investment managers. Until now, the Swiss regime for managers of separate accounts (as opposed to investment funds) has been very liberal in terms of company registration and distribution of services. However, there could be a twist in the tail. With one eye on

Brexit, Swiss politicians are wondering if MiFID II-style regulation is the right way to go, given that the EU is less receptive to granting market access to third countries. It is just possible that Switzerland may look more to serving other markets than the EU.

In **Canada**, driven by investor protection and market efficiency concerns, the Canadian Securities Administrators (CSA) issued a staff notice in June 2016 proposing significant changes to mutual fund fees. The notice focuses on discontinuing embedded commissions (sales and trailing commissions) paid to dealers and their representatives. There is also a ‘best interest’ standard for advisors, dealers and representatives.

In the **US**, the SEC and Treasury Department have identified issues with the sales practices of certain wealth management firms, specifically their incentive compensation structures. Because of their bonus and compensation structure, financial advisors were incentivized to steer clients to in-house mutual funds and other proprietary investment products rather than external products that may have been more suitable for the investors.

The heightened scrutiny of sales practices has prompted some private banks and other wealth management firms to revise their policies and procedures relating to potential conflicts of interest regarding their disclosure and compensation policies.

In **India**, with effect from October 2016, fund investors must be made aware of the amount of commissions paid to distributors out of the total ongoing charges of the fund. SEBI has also instructed fund managers to show an illustration of the effect of the total ongoing charges on returns and is urging managers to adopt industry guidelines on capping at 1 percent the amount of initial commission paid to distributors.

In a separate move, SEBI is pushing managers to merge funds with similar investment strategies in an effort to halve the number of funds offered by domestic managers, and so improve costs and operational efficiencies.

Simple and meaningful cost disclosures remain elusive

In October 2016, the **South African** regulator launched a “meaningful cost comparison across investment products,” allowing consumers and advisors to compare charges and their impact on investment returns across most savings and investment products. All members of the Association for Savings and Investment South Africa are required to adopt a standard on Effective Annual Cost.

In **Europe**, MiFID II includes requirements for distributors to provide to their clients the total cost of ownership: aggregate figures for the costs of investing, both within the product and along the distribution chain. The Directive also requires portfolio managers to provide their clients with the total costs of the service they receive. The detailed rules underpinning these requirements are proving contentious, not least as regards the methodology for calculating the underlying transaction costs within a fund.

It is not the only bone of contention for the industry. In October 2016, the European Parliament rejected the Regulatory Technical Standards (RTS) essential for the functioning of the PRIIP KID. As a result, the Commission announced a delay of one year to the implementation deadline while it amended the rules on the performance scenarios methodology, the use of the fourth (“market stress”) scenario, the comprehension alert

and Multiple Option PRIIPs. The date for implementation is now in line with the revised deadline for MiFID II of January 2018.

However, the hope of a full year for product manufacturers to develop, test and produce thousands of KIDs has again been dashed. In another twist, in January 2017, the ESAs said they did not agree with the proposed revisions. After further debate, the Commission took over the lead and issued revised RTS, which were accepted by Parliament and Council, and published as final in April 2017.

The new RTS do not, though, include changes to the methodology for computing costs or their presentation. The fund management industry has consistently expressed concerns that the presentation of costs could mislead investors into thinking they are less than they are and that the methodology for transaction costs will often give rise to negative or overly-inflated, and therefore misleading, figures.

Meanwhile, many question whether the document will be used by investors. The two-page UCITS KIID, introduced in 2012 with the arrival of UCITS IV, describes a fund's objectives and investment policy, risk and reward profile, charges and past performance. However, representations to the Commission suggest that the document is not regarded by investors as useful.

Germany's fund trade body, the BVI¹, said in January 2017 that one reason the document has failed is because the synthetic risk and reward indicator, which has a one to seven scale for a fund's risk, is unreliable. The BVI said "it remains to be seen" whether the PRIIP KID will fare any better.

The **UK** regulator, in its interim report on its study of the investment management sector, also pointed to a low level of investor engagement with the KIID. It said only 25 percent of non-advised retail investors look at the KIID when choosing a fund.

And in the **Netherlands**, the Dutch Investors' Forum said its own research found that less than half of retail investors use the document.

Closet trackers: regulators name and shame

In last year's report (EIMR 2016), we forecast that closet index tracking was shaping up to be one of the hottest European regulatory topics of the year and could have significant reputational repercussions for the fund industry. And so it proved.

The debate, already live in many jurisdictions, heated up substantially after ESMA analysis in 2016 found that between 5 percent and 15 percent of UCITS equity funds could potentially be closet trackers – funds that charge an active fee but do little more than hug a benchmark. ESMA suggested that further investigation be conducted by national regulators.



¹ Bundesverband Investment und Asset Management

EU spotlight on “closet trackers”



“... room for improvement regarding the information provided to investors.”

Perhaps the strongest reaction to ESMA's report has been seen in **Norway**, where the regulator publicly reprimanded a firm. Most other regulators have been reluctant to single out individual firms.

Sweden joined its Nordic neighbor by announcing in January 2017 that it had identified more than ten fund managers that offer funds with a low active share (below 60 percent). However, it stopped short of accusing them of being “closet trackers”. It, too, named the firms.

Sweden later proposed legislative amendments to tighten disclosure requirements for fund managers, following a high-level inquiry into closet index funds. The government will put forward proposals before elections in 2018 for fund managers to “declare how active or passive [their funds] are”. However, the Ministry said it would still be up to the consumer to decide if the fund fee was appropriate.

Funds in **Germany** will be forced to adopt new transparency rules after an inquiry found that some active funds “closely” track their index. The investigation into closet indexing, initiated by BaFin in April 2016, looked at 290 funds, each with assets of more than EUR10 million and each with more than half of their holdings in equities.

BaFin said there was no evidence that any active funds in Germany “solely” track an index, but it did identify active funds that “closely” follow their benchmark. However, these funds tended to have “significantly lower management fees than is normal for actively-managed funds”. In addition, the funds are no longer marketed, according to BaFin.

The regulator sees no reason to intervene on this basis, but did say there was room for improvement regarding the information provided to investors. It plans to introduce new transparency requirements for investment funds

that have more than half their assets in equities. From the middle of 2017, German funds are required to explain explicitly to investors whether they are actively-managed or track an index. Fund prospectuses will have to include the fund's long-term performance in relation to its benchmark.

Meanwhile, in **Italy**, the financial regulator announced in January 2017 that "remedial action" had been taken against some of the 10 largest fund houses it investigated over the issue. The regulator did not name the fund managers, but said it had forced them to alter their fund documentation to ensure the investment policy was consistent with the actual management.

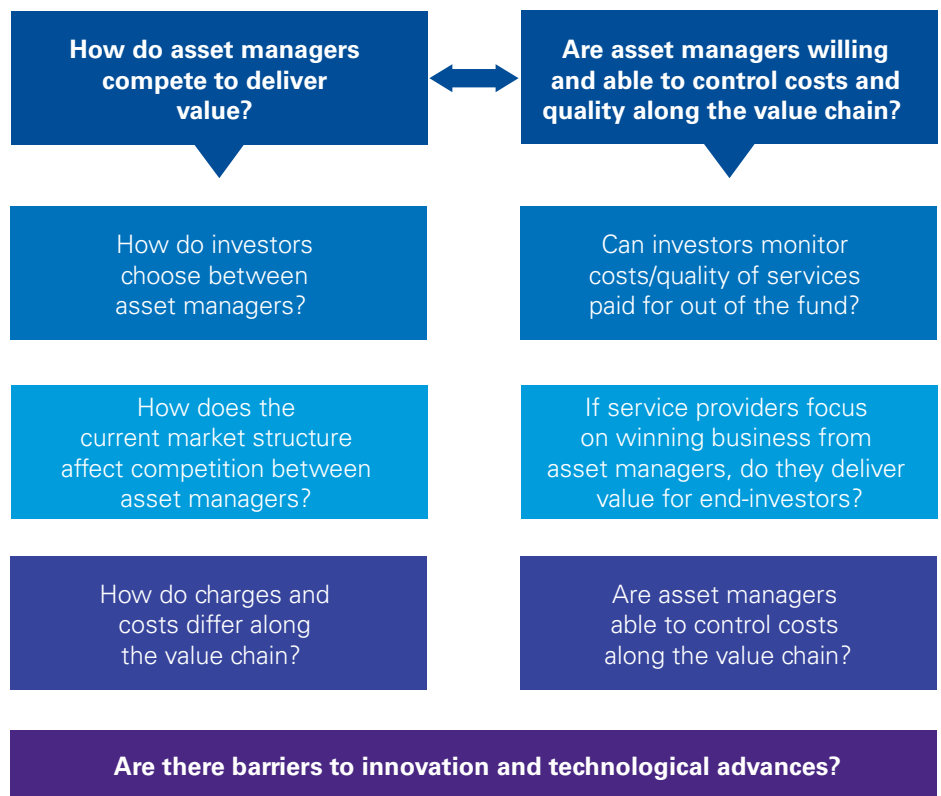
Closet-tracking identification methodologies under the microscope

The methodology – or lack of it – for identifying closet tracking funds has been questioned by the industry and some regulators.

EFAMA, for one, argues that relying on active share and tracking error to determine whether a fund is a closet tracker is misleading. Small-cap funds, funds with small assets under management and products with a diversified benchmark are all more likely to have higher active share, says EFAMA, making it easier for these funds to demonstrate active share higher than 60 percent. This compares with large-cap funds or, say, funds benchmarked to single-country markets, in which a few companies represent a large part of the index. A fund's active share can also fall in stressed markets as fund managers reduce the size of their active bets.

EFAMA also disagrees with the view that funds with an active share of less than 60 percent should automatically be

Key questions in the UK Asset Management Study



classified as closet trackers. If national regulators do use a methodology based on active share, EFAMA believes fund-by-fund analysis, including other quantitative and qualitative dimensions, should also be employed.

France's financial regulator has also criticized the methodology. The AMF said that based on its own analysis of the funds identified by ESMA as potential closet trackers, there were no French closet trackers.

Meanwhile, campaign group Better Finance disclosed the names of 62 funds with "high potential" of being closet indexers. Of these 62 funds, Better Finance said "many" do not disclose their benchmark's performance alongside their own performance in their KIID. This makes it impossible for the retail investor to assess whether and by how much a fund is hugging its benchmark. Better Finance has referred its findings to ESMA, which said it would raise the issue with national regulators.

Level of fund management fees under scrutiny

The regulatory debate on the level of fund management fees is widening. In December 2016, the wide-ranging interim report of the **UK** FCA's Competition Division's review of the UK asset management industry was tough-talking. It included a number of damning findings and proposed a series of "remedies"

The report said that active funds rarely outperform and are guilty of "considerable price clustering". It was also critical of the industry's failure to promote passive products to retail investors. Its stance would appear to indicate an endorsement, intended or not, for passive products. The regulator seems to suggest that active funds are appropriate only if there is no passive vehicle that can offer similar exposure.

Key FCA findings from the Asset Management Market Study

- Weak price competition, despite a large number of investment and fund management firms. But competitive pressures are building in some parts of the market.
- Cost control is mixed – good where straightforward to manage and inexpensive to control (e.g. safe-keeping of fund assets), but less good where more expensive to monitor value for money (e.g. trade execution and foreign exchange transactions).
- Charges for passive investment funds have fallen over the last five years, but charges for actively-managed funds have not and are clustered around specific pricing points. As fund size increases, the management charge does not fall.
- Firms have consistently substantial profit margins of 36 percent on average.
- The *ad valorem* fee model incentivizes growth of assets rather than value for money.
- Most expensive funds do not appear to perform better than other funds, and many active funds offer similar exposure to passive funds but charge significantly more.
- Investors do not receive estimates of transaction costs in advance.
- Concerns about how managers communicate investment objectives and outcomes.
- Investors focus on past performance, which is not a good indicator of future returns.
- Fund governance bodies do not focus on value for money.

“... an all-in fee that would indicate all the charges investors will pay ...”

This stance is at odds with other expert opinion. The **Hong Kong** regulator, for example, has expressed concern that the rise of passively-managed index-tracking funds could harm corporate governance standards in the territory.

Some in the industry have expressed doubts to the FCA about the reliability and accuracy of the data it used. The UK fund body, the Investment Association, says the report does not distinguish between different types of active funds and seems to suggest that active funds should take on more risk to justify higher fees.

Ratings agencies have also expressed doubts over the FCA's findings. In November 2016, Moody's noted that the regulator's proposals could squeeze the profit margins of active fund

managers, saying the FCA's proposed fee structure will require significant expense reduction. Moody's said competition from passively-managed products would require investment managers to “adapt their business models.” According to the rating firm, managers that move first “will be most resilient” to changes in the regulatory and market environment.

One of the FCA's proposals is for an all-in fee that would indicate all the charges investors will pay, including transaction costs incurred when a fund manager trades. The interim report found that “some charges, particularly transaction costs, are not disclosed to investors before they make their investment decisions.”

Of the four options proposed for the all-in fee, three would require the manager to predict future transaction costs (as will be required by the PRIIP KID). Currently, fund managers are required to disclose in the UCITS KIID an ongoing charges figure based on costs incurred by each fund over the previous year, excluding transaction costs and any performance fee. One option would require the manager to pay for any overspend in predicted transaction costs. Another would require the manager to pay back to the fund any underspend.

According to the FCA, an all-in fee would allow investors to “easily see what is being taken from the fund.” A number of fund houses have already introduced measures similar to the FCA's all-in fee

The FCA's proposed remedies to asset management issues

Strengthened duty on investment managers to act in the best interests of investors.

In relation to investment funds:

- independence of fund oversight committees
- an "all-in fee approach" to quoting fund costs and charges
- clarity about fund objectives
- appropriate use of benchmarks
- investor tools for identifying persistent underperformance
- easier switching into cheaper share classes
- clearer communications on fund charges
- increased transparency and standardization of costs and charges information.

In relation to pension funds and other institutional investors:

- potential benefits of greater pooling of pension scheme assets
- increased transparency and standardization of costs and charges
- clearer disclosure of fiduciary management fees and performance
- provision of institutional investment "advice" should come under FCA regulation.

proposals. However, some may set the all-in fee figure at a level that is high enough to "generate certainty" for investors, which could result in higher fees. The FCA acknowledges this risk. Most of the criticism in the study is levelled at the difference between charges for institutional and retail investors and at actively-managed funds. It is said to be difficult for investors to assess the value for money of MMFs, protected funds and targeted absolute return funds. External fund ratings are said to be biased towards actively-managed funds. In addition, while performance fees are not common in UK retail funds, where used, they are often asymmetric.

In the institutional market, pension fund trustees said they sometimes struggle to scrutinize the performance of their investment portfolio as a whole. The FCA notes that information presented by the investment manager is often in a format that is difficult for the client to understand and engage with.

The report acknowledges new requirements under the PRIIP KID Regulation and MiFID II. Some of the FCA's proposed "remedies" are in line with the thrust of these regulations, but others indicate that the FCA is prepared to consider more detailed or, perhaps, different solutions. Coupled with the already stringent UK requirements on inducements, this approach could lead to a greater differential in the regulation of UK investment markets versus the rest of Europe.

Meanwhile, in **Ireland**, the CBI is conducting a thematic review of ongoing charges in UCITS. Its focus is on the quality, comparability and presentation of fee disclosures and, in particular, whether disclosures allow investors to make informed investment decisions. The aim is (a) to build a data-driven approach to the understanding of ongoing charges and (b) to identify funds that are outliers.

The annual submission of UCITS KIIDs forms the basis of this review. In conjunction with other regulatory returns, the KIIDs were analyzed to

provide a comparison of fees at a share class level. The review included both actively- and passively-managed investment funds across the spectrum of equity, bond, money-market and mixed mandates.

Work on fees is due to carry on throughout 2017. The CBI has also announced it will consult further on the disclosure of fees and charges. Information gained from this work will inform its own contribution and input into wider European initiatives on fees.

Remuneration – rules could go either way

In EIMR 2016, we noted that remuneration was high on the regulatory agenda, with IOSCO recommending that the remuneration of the management company be disclosed separately from other costs and charges within investment funds. In **Europe**, the debate was focused on the disclosure of remuneration levels of key individuals within firms – including senior management and portfolio managers – and the firms' remuneration policies.

As the debate progressed in the latter half of 2016, the industry received mixed messages on the remuneration issue. CRD IV, which came into force at the start of 2017, includes a cap on bonuses for material risk takers at 100 percent of fixed salary, or 200 percent where there is shareholder approval. However, in July 2016, the European Commission said it was considering waiving strict banking remuneration rules for some non-banking groups – including investment managers. The Commission wrote to the European Council and European Parliament, saying it would conduct an impact assessment on allowing rule waivers.

The Commission said the application of certain CRD IV remuneration provisions – particularly those on deferral and payout in instruments – "is not efficient if consideration is given to the particular

costs and burdens triggered by the rules on the one hand and the absence of clear beneficial effects on the other.”

However, the European Banking Authority (EBA) launched a data collection exercise asking investment managers to provide specific information on staff falling under the new rules. In December 2016, it announced that the bonus cap should apply to all firms caught under the Directive, including bank-owned subsidiaries and independent firms.

The industry is hoping there will be some flexibility. EFAMA said that imposing CRD IV pay rules on investment managers will impact firms’ ability to attract and retain top talent.

in a larger number of investment management staff in the country falling within the scope of the remuneration rules. The Dutch Minister of Finance said he wanted to extend a bonus cap for material risk-takers to all staff at firms caught by the rules, regardless of their role.

The Dutch proposal, which goes further than the EU provisions, would extend the bonus cap to staff whose functions are not deemed to have an impact on their firm’s risk profile. The Netherlands already has a bonus cap of 20 percent in place for financial services firms. However, UCITS and AIF managers have, until now, been exempt from the rules.

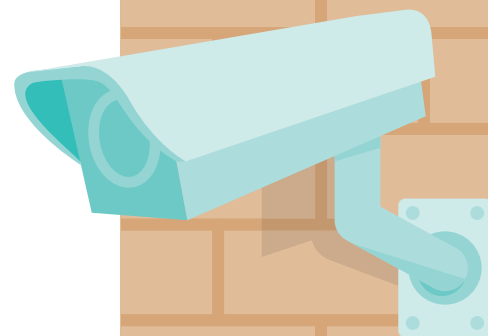


In the **UK**, the Prudential Regulation Authority and the FCA said they would not apply the pay guidelines to UK standalone fund houses.

Similarly, in **Ireland**, the CBI set out in January 2017 “proportionality” principles for the payment of variable remuneration to certain banks and investment firms. Its assessment of quantitative aspects will be guided by threshold levels related to the size of the firm and the level of variable remuneration.

The **Netherlands**, however, is decidedly on the other side of the debate. It has tabled proposals that could result

Investment fund managers must also navigate differences between UCITS and AIFMD requirements. The latter allow for the application of proportionality, but the final ESMA remuneration guidelines (which cover both UCITS and AIFs) are less flexible. The **French** regulator, for one, has clarified that it will align its approach to that under AIFMD.



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