

## EFAMA's comments on the ESAs' Joint Consultation Paper concerning amendments to the PRIIPs KID

### GENERAL REMARKS

EFAMA<sup>1</sup> welcomes the ESAs' initiative to begin to address the shortcomings of the current PRIIP KID, which are causing serious investor detriment by mandating methodologies and presentations, particularly in relation to performance and costs, that at best confuse investors and at worst mislead them. We are, though, concerned about the very limited scope of the consultation.

The full review of the PRIIPs Regulation, originally scheduled to be completed by the end of 2018, needs to be commenced and completed as soon as possible to address the various pressing issues with the current rules. We are therefore concerned by the ESAs' comment that the "comprehensive review of the PRIIPs framework [...] is expected to be completed in the coming years",<sup>2</sup> which implies that the European Commission has made a unilateral decision to defer the timing of the full review.

We also have fundamental issues with the ESAs' approach to the UCITS KIID. It is not in the best interest of retail investors to support the Commission's intention to "phase out" the UCITS KIID by the end of 2019, ahead of the full review. This would upend the original sequencing as set out in the PRIIPs Regulation and would require "quick fixes" to be introduced with insufficient time to consider the many technical and practical issues that will arise. The amendments would need to be agreed by the European co-legislators, at the latest in Q2 2019 – only weeks before a new European Parliament is elected and a new European Commission is constituted. PRIIPs manufacturers and regulators would then need to rush to implement these changes in a matter of weeks by 01 January 2020.

Such "quick fixes" followed by a larger review will also result in iterations of the PRIIP KID in a very short timeframe. We fear that such constant revisions will adversely impact retail investors' comprehension about and trust in investment products and financial markets, at a crucial time when the EU is trying to foster their participation through the CMU project. Also, it may result in investors being even less likely to study carefully the KI(I)Ds before making an investment decision. The potential continuation of the retail-centric UCITS KIID for professional investors is an additional concern.

Furthermore, even though previously disregarded concepts are now being (re-)discussed by the ESAs, stakeholders are given only four weeks to respond and are being told that there will be no further stakeholder consultation to test the ESAs' chosen solutions. More importantly though, no additional consumer testing is being planned to ensure that the proposed amendments will actually address the current shortcomings. The amendments suggested by the ESAs may partly address a small number of

<sup>1</sup> EFAMA is the representative association for the European investment management industry. EFAMA represents through its 28 member associations and 62 corporate members close to EUR 23 trillion in assets under management of which EUR 15.6 trillion managed by more than 60,000 investment funds at end 2017. Just over 32,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 28,100 funds composed of AIFs (Alternative Investment Funds). Please visit [www.efama.org](http://www.efama.org) for further information.

<sup>2</sup> ESAs' consultation paper, p. 12

the issues, but could have other unforeseen negative consequences. The very short consultation period and the lack of consumer testing make such unintended consequences more likely.

This unreasonable haste has another very unfortunate side effect that will negatively affect the outcome of these discussions. Due to this very limited timeframe to draw up amendments (by Q1 2019), the ESAs have decided not to collect evidence on all other issues currently outstanding with the PRIIP KID, but have limited their review to performance scenarios. While we have always agreed that this issue is of utmost importance, other topics such as costs disclosures (e.g. the transaction costs calculation and the presentation of costs) are equally important and need to be addressed. EFAMA uses this consultation again to bring forth these issues and asks the ESAs to fix the well-publicised shortcomings as a matter of priority.

That being said, the Commission's reported deferral of the full review creates another issue. While targeted changes to the Level-2 requirements may address some issues currently plaguing the PRIIP KID, other issues can be solved only through changes to the Level-1 Regulation. Again, this underlines the need for a full review, as originally specified by the co-legislators, that focuses on *all* the issues of detriment to retail investors, as repeatedly raised by EFAMA and other stakeholders.

Given the very limited scope of this consultation, which fails to address all outstanding issues, we are calling on the co-legislators to extend the exemption for UCITS in order to reinstate the original timeline and to allow time for a proper review of the PRIIP KID. In light of the recent developments, we therefore stress our full support for the European Parliament's ECON Committee's proposal extend the UCITS exemption until 2021.

Our comments on the points raised in this consultation should not be seen as any sort of endorsement to address substantial issues with rushed quick-fixes to the PRIIPs Delegated Regulation and its Annexes. We consider this ESA consultation and our comments as only a first preparatory step towards a full review. EFAMA reiterates that the process and sequencing (of review, targeted amendments where necessary and subsequent roll-out of PRIIPs to UCITS) specified by the co-legislators in Articles 32 and 33 of the PRIIPs Regulation must be followed in order to avoid regulatory failure.

**ANSWERS TO QUESTIONS****1. Do you agree that information on past performance should be included in the KID where it is available?**

We agree that information on past performance should be included in the PRIIP KID, where it is available because it will support the assessment by investors of the real net return of retail investment products. We believe that this is in line with the wording of the PRIIPs Regulation, which requires the disclosures of “appropriate performance scenarios”. This wording provides flexibility to ensure that the information given to investors is appropriate and relevant.

There is, therefore, a case to be made between appropriate performance scenarios for linear products and for non-linear (i.e. structured) products. The problems around the current performance scenarios have demonstrated that projecting a linear product's past performance into the future can and will provide misleading information. Our experience in showing only past performance for non-structured UCITS has proven successful with investors for multiple reasons. However, performance scenarios (not necessarily in its current implementation) for structured products can have merits for investors in making informed investment decisions. The same distinction is made in the UCITS KIID framework which makes special considerations (i.e. a third page on performance scenarios) for structured UCITS.

The current changes proposed by the ESAs, however, do not go far enough in making this distinction, as they are suggesting simply to add past performance information to the existing future performance scenarios. We doubt that this addition will provide a ‘catch-all’ solution for the current performance scenario woes. This is in particular the case currently, given that past performance data is based on the strong economic performance of the last ten years. Within that overall trend, though, the performance history of a product will fluctuate. When presented in a bar chart form (as in the UCITS KIID), this helps investors to understand that the value of investments can go up as well as down.

The future performance of structured products, such as structured UCITS, is dependent on specific market events or scenarios. It is appropriate and necessary for investors to be informed of how the product will work in such scenarios, as required under the UCITS KIID. However, future performance scenarios are not suitable for linear products, such as non-structured UCITS and AIFs, especially when such scenarios are derived from past performance data.

Future performance scenarios for linear products distract from the PRIIP KID's objective of describing investment products in a fair, clear and not misleading way, as such scenarios will necessarily incorporate a certain market view, which could be seen by many retail investors as a firm promise of return. The disclosure of past performance is well-tested for UCITS. It clearly is not a guarantee of the future, but gives an indication of how the fund has operated in the past vis-à-vis a relevant benchmark. It is factually correct and cannot be gamed because it is presented in a standardised format. Also, the UCITS KIID includes a prominent warning about the relevance of past performance, highlighting that it is not a reliable indicator of future results

For these reasons, EFAMA continues to insist on its long-standing demand (which is shared by investor representatives) that past performance should be the only performance indicator for linear products (in line with the current UCITS KIID framework). We therefore urge that changes be made to the Level-1 Regulation explicitly to implement this recommendation in the PRIIP KID.

That being said, we see substantial practical problems with the introduction of past performance into the current KID framework. If – as is being suggested by the ESAs – the past performance disclosures follow the current UCITS KIID rules, the past performance disclosure will take up approximately one-half of an A4 page. This is confirmed by the example on page 17. Given the already dense information being provided and, more importantly, the Level-1 requirement to limit the PRIIP KID to three A4 pages, we do not see how this information can be included without seriously impeding the overall legibility of the PRIIP KID.

There seem to be further technical issues that have not yet been sufficiently addressed by the ESAs and which need further in-depth discussions. This relates in particular to the inclusion of past performance into the PRIIP KID based on the current UCITS KIID framework which cannot simply be included in the PRIIP KID. The reason for this is that the definition of costs diverges between the two frameworks. As the UCITS KIID shows past performance net of costs and assuming that the definition of costs in PRIIPs would prevail, this lead to a situation where fund managers are required to recalculate all past performance data to take into consideration the different PRIIPs environment.

We therefore suggest that the inclusion of past performance should be confirmed as part of the comprehensive PRIIPs review and accompanied by potential changes to the Level-1 Regulation including the PRIIP KID's length.

## **2. Are there challenges to include past performance information for certain types of PRIIPs?**

Structured UCITS are currently not required to include the past performance section, since this information might not be available or useful (or, in some cases, even misleading) for the investor to understand the essential elements of the product. We believe that this should also be the case for structured UCITS when producing PRIIP KID-like information or, at some point in the future, a PRIIP KID.

The above comments show that there is a strong case for a detailed and thorough discussion and potential reconsideration of the concept of performance-related information in the PRIIP KID. Broadly speaking, we could envisage a differentiation of performance presentation for PRIIPs with different return profiles (linear vs. non-linear) based on the UCITS model described above. However, this would need to be accompanied by a general debate about whether – in certain instances – reliability of information is more important than full comparability for all types of PRIIPs. In any case, we would expect the issue of comprehensible and appropriate performance information to be one of the priorities for the forthcoming PRIIPs review.

Last but not least, we understand that there may be substantial challenges for certain types of non-fund PRIIPs to include past performance information, which need to be recognised. It is for the ESAs to design a flexible but robust framework, with a view to ensuring overall comparability between the information laid out to retail investors for all types of PRIIPs while recognised key differences between products.

**3. Do you agree that it is appropriate for this information on past performance to be based on the approach currently used in the KIID? If not, please explain your reasons and if an alternative presentation would be more appropriate and for which types of PRIIPs?**

Experience with the current UCITS KIID framework provides invaluable input to the overall debate on key product disclosures for retail investors. It should therefore not be discarded as lightly by the ESAs and the European Commission as it seems to be the case.

When information on past performance is included in the PRIIP KID, we strongly believe that this information should be based on the UCITS KIID framework. This information is highly standardised and has been in use for more than seven years now, allowing retail investors to understand the nature of the disclosure.

Furthermore, we understand that this view is shared by investor representative organisations which, in particular, underline the value of the standardised nature of the disclosure. This includes the required use of an appropriate benchmark, where the investment approach of the fund includes or implies a reference to a benchmark, to enable (potential) investors to compare a fund manager's past performance with his peers as well as against the benchmark.

**4. Do you think that information on simulated past performance should be included in the KID where actual past performance is not available? If not, please explain your reasons.**

**5. If you think that information on simulated past performance should be included in the KID, what approach do you think should be used to simulate the past performance, and how should this be presented in the KID?**

The UCITS KIID framework already provides appropriate considerations for the use of simulated past performance. This is laid out in Article 19 of the UCITS KIID Regulation (Commission Regulation (EU) No 583/2010) and its importance cannot be overstated. Specific rules that are already contained in the UCITS KIID framework must in future be correctly transposed into the PRIIPs rules. For example, the UCITS KIID rules take into account the situation of existing funds launching new shares classes. In these instances, it is allowed to use past performance of the already existing share class while making adjustments to its fees.

Such principles are paramount and must be maintained. At a high level, we suggest that these principles could be applied to all types of PRIIPs, but as noted above, it is important that the detailed rules accommodate the very different types of PRIIPs in a robust but flexible way.

Whether or not simulated past performance is an appropriate measure for other types of PRIIPs (i.e. non-fund PRIIPs) for which actual past performance is not available is a complex question, which should be carefully assessed after analysing market evidence, arguments brought forward by relevant stakeholders and the results of consumer testing.

More generally, simulated past performance information must be in line with Article 44 of the MiFID II Delegated Regulation 2017/565, which provides a clear framework for "fair, clear and not misleading information requirements" in the context of past performance, simulated past performance and future performance scenarios. While such detailed rules on these three areas do not exist under the Insurance

Distribution Directive, the same principle of “fair, clear and not misleading” information applies to all insurance products (Article 17).

With regards to the ESAs' suggestion to simulate past performance for structured products (including structured funds), it should be remembered that the UCITS KIID seeks to keep the use of simulated past performance to a minimum. In essence, simulations based on historical data should be treated separately and differently from the indication of (real) past performance. They should be assimilated to the scenario rather than historical information on product performance.

Furthermore, there may be drawbacks with both proposed options, in addition to those indicated in the document. For the first option, there could be cherry picking based on the results of the simulation of the pay-off structures; and for the second option, the price histories of the underlying assets of a new structured fund (which at the date of issuance has no price history) could not be linked to the price (NAV) of the structured fund itself as this price would be available only after issue.

It is not clear to our members whether the ESAs intend that new PRIIPs will still be required to provide performance scenarios using index or representative portfolios in cases where they are unable to provide historical performance. We propose that in these instances, and in addition to the statement required under UCITS Directive explaining that there is insufficient data to provide useful indication of past performance, KID producers should be permitted to put the performance scenarios in context by explaining the basis of the calculation, emphasizing that these are estimates and including a note on potential volatility.

We understand the complexity of these discussions and again strongly underline that such decisions should be based on proper consultation with all stakeholders and the results confirmed by consumer testing. For this reason, we believe that such a question should be tackled in the full review of the PRIIPs Regulation rather than in this time-constrained exercise.

#### **6. Do you consider these amendments to the narrative explanations to be an improvement on the current performance scenario approach?**

While amendments to the narrative explanations are a move in the right direction, they will not mitigate the far more profound issue of presenting misleading performance scenarios to investors. Such issues cannot be solved by tweaking the “small print”.

In the light of the above comments and taking into account the extremely short consultation period, please find attached some non-exhaustive comments on the narrative explanations:

(1) The key message in bold should be adapted, as follows, in order to send a clear message to investors about the relevance of the simulated performance scenarios and the basis for such simulations:

**“Future market developments cannot be predicted. These scenarios are only an illustration of the range of possible returns based on past performance data. Do not rely on them for your investment decision.”**

(2) The new text, suggested to replace elements A to D, should allow for more flexibility for different types of PRIIPs. In particular, the clause “and does not take into account the situation where we are not able to pay you” may not be relevant for all PRIIP KID (manufacturers), in particular, for traditional

investment funds.<sup>3</sup> This should therefore be marked as wording for products that are dependent on the solvency of the PRIIP manufacturer or another entity. As a result, the following text elements should be put in square brackets:

“This table indicates how your investment could perform over the next [recommended holding period] [years] in different market circumstances, assuming that you invest EUR [...] [per year]. These are estimates based on relevant data from the previous [x] years [, **and does not take into account the situation where we are not able to pay you**].

(3) We would also like to confirm that the ESAs do not intend to change any other elements, such as Element F. We raise these comments based on the example on the page 17, which states that the portrayed PRIIP “includes the costs of your advisor or distributor”. The current Element F allows for both PRIIPs containing retrocessions and PRIIPs that are retrocession-free. This flexibility must be maintained. Also, even PRIIPs that include retrocessions cannot necessarily know whether the amounts taken from the PRIIP are the total costs of the advisor or distributor. The text might more accurately say “includes **amounts paid to** your advisor or distributor”.

Moreover, we recommend that KID producers are allowed to include additional narrative to put the calculation in context and for the narrative not to be buried in ‘small print’, either by highlighting it in bold or including it in a separate section called ‘Important information about the calculation of performance scenarios’.

#### **7. Do you have any comments on the analysis set out in this Section of other possible options to improve the future performance scenarios?**

We do not believe that a wider discussion on the overall methodology of the performance scenarios should be included in a consultation on “targeted amendments”. We also note that the options raised by the ESAs have already been disregarded at an earlier stage in the Level-2 process, which begs the question why they are brought back to the table in a consultation with such a narrow scope.

Given that the current performance scenarios are providing misleading information to investors, EFAMA members have spent considerable time and resources looking into the previously disregarded alternatives and testing their outcomes on real-life data in order to contribute to finding a solution. Again, these do not constitute our final conclusions, but preliminary evidence highlights the following:

While extending the historical period used to measure performance has the potential to smooth some of the current symptoms, such as excessive numbers being presented, it does not solve the actual problem of projecting past performance into the future. Even figures with longer observation periods are a reflection of the past/current economic cycle and can therefore lead to reinforcing these trends well into the next economic cycle.

The other option, to base performance scenarios for all PRIIPs on the risk neutral performance expectation, disregards the risk premium of certain assets (in particular, equities) and other product-specific performance features. It is therefore also not a viable way forward.

<sup>3</sup> Assigned CRM 1 in accordance with para. 46 of Annex II to the PRIIPs RTS

Stressing again that performance scenarios are not suitable for linear products, any potential new methodologies and their outcomes must be rigorously tested and thoroughly assessed in the light of our comments above. In particular, they must be consumer tested to ensure that the information provided is of benefit to retail investors and does not have the serious potential to mislead investors, as is the case for the current performance scenarios.

Again, such a discussion should take place as part of the wider Level-1 review of the PRIIPs Regulation and cannot be thoroughly undertaken in such a rushed and limited process as now suggested by the ESAs and the European Commission.

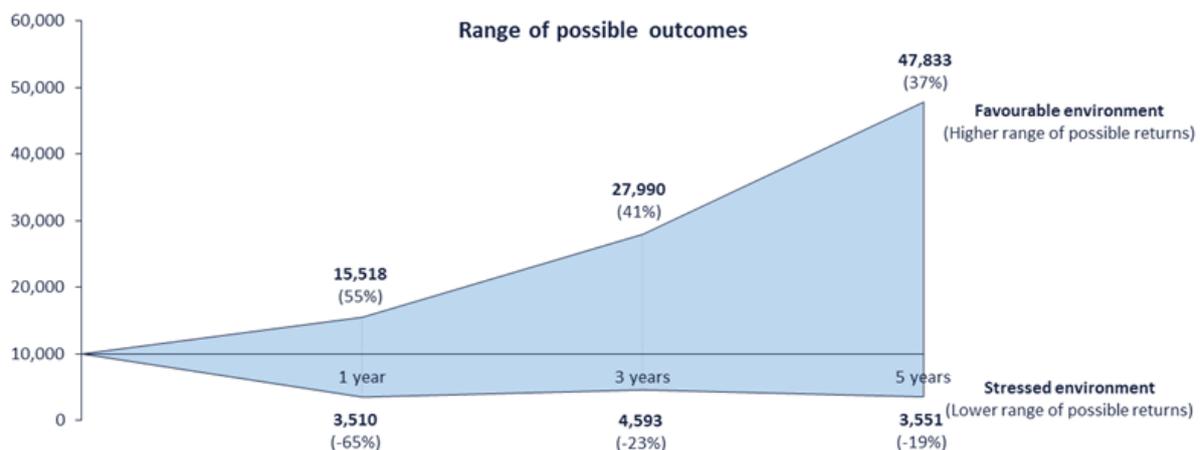
**8. Do you have any views on how the presentation of the performance scenarios could otherwise be improved?**

As stated above, performance scenarios are suitable only for structured products. For these products (such as structured UCITS), we believe that the current UCITS KIID framework is best suited in terms of methodology and presentation of the performance scenarios.

If the Commission and the ESAs insist on continuing to provide performance scenarios for all types of PRIIPs, we recall the outcomes of the own consumer testing that was carried out during the drafting process of the current delegated acts. Consumers were clearly in favour of the current format, which they found easier to understand than graphical presentations. While EFAMA has sympathy for using graphical presentation, we trust and support that the results of the previous consumer testing are in the best interest of investors and should therefore not be second-guessed.

As stated numerous times previously, it is less that the presentation of the performance scenarios creates issues than that the underlying methodology leads to the disclosure of misleading figures.

This is again evident in the contrast between (well meaning) theory and actual outcome in the example on page 39. The ESAs' suggestion to use a "funnel of doubt" presentation will not solve the underlying shortcomings of the methodology. The ESAs insinuate that a funnel will equally present positive and negative future outcomes, but the existing methodology is most likely to result in a presentation with a large skew towards overly positive outcomes (as in our own example shown below), that will continue to misinform investors.



Taking into account our views on the value of performance scenarios for only structured products, we recall that the reason why a fourth scenario (i.e. a stressed scenario based on a fundamentally different approach to the existing three scenarios) was added to the PRIIP KID, on the request of the European Parliament, was the overly optimistic predictions portrayed in the other three scenarios. This already highlighted the inherent flaws of the methodology. Instead of deliberating alternative presentations such as a funnel between a favourable and stressed scenario (which are based on different methodologies), it is imperative to find an appropriate methodology that addresses the current fundamental flaws in the numbers that must be presented. The “unfavourable” scenario will then reflect its name and the fourth stressed scenario will be redundant.

## **9. Do you agree with the proposals described in this section?**

We have the following comments on the proposals described in this section. Again, as we had very little time to conduct a proper in-depth analysis, our comments should not be considered as exhaustive as further investigations might bring up other important aspects.

### (1) Market risk measure (MRM) calculation for regular investment or premium PRIIPs

With regards to the MRM calculation for regular investment or premium PRIIP, we generally agree that regular investments could have a lower risk than one single investment. That being said, that assumption should be empirically tested considering the extension to different risk classes, especially when the approach proposed could be very burdensome.

In the light of the above, we have serious concerns with the ESAs' suggestions regarding the prescription of the calculation for regular investment or premium PRIIPs. First, the relevant formulae are described only in general terms, but are not laid out in the paper, which makes testing any assumptions very difficult. More importantly though, we fundamentally disagree with the ESAs' suggestion to allow the use of only one formula going forward. We understand from EFAMA members that different approaches producing broadly similar results are currently being applied and are accepted in practice<sup>4</sup>.

A discussion about further enshrinement of any approach should take place as part of the wider Level-1 review of the PRIIPs Regulation and cannot be thoroughly undertaken in such a rushed and limited process as now suggested by the ESAs and the European Commission.

### (2) Narratives for the Summary Risk Indicator

On the narratives for the Summary Risk Indicator (SRI), we note that the length limit is to be raised from 200 to 300 characters. As welcome as any increase in length is, it is still not nearly enough properly to explain additional risks to investors. A character limit is also not helpful in a cross-border environment for the translation into some EU languages where a higher word count (up to 30% extra for German and Finnish, for example) limits the disclosures further. There should be no character limit,

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<sup>4</sup> Two of these approaches are detailed in the Comfort European PRIIPs Template (CEPT) which is the industry's standard for the provision of PRIIPs-relevant information on underlying investment options. More information can be found here: <https://www.efama.org/Publications/Public/PRIIPs/UpdatedEPTandCEPTIntro.pdf>

thus allowing informative disclosures to be included by the PRIIP manufacturer, within the overall PRIIP size limit.

(3) Narrative for Performance Fees – composition of costs table

We are very much in favour of the proposed flexibility.

(4) Growth assumption for the RIY calculation

We find it peculiar that the ESAs are suggesting to extend the growth assumption of 3% to all PRIIPs, instead of using the current PRIIPs' methodology to calculate future performance scenarios. This suggests the ESAs' lack of trust in the current situation. Instead of providing a blank extension of a 3% growth assumption to all PRIIPs, we suggest the following two-step approach:

- (1) In line with our remarks in the "additional comments" section below, under the heading "Costs on a Reduction-In-Yield basis are too difficult to understand for retail investors", changes should be made to the second cost table, which should present costs as an annual percentage (similar to the current UCITS KIID maximum costs disclosures). This would mean that this table would in effect contain a 0% growth assumption. While allowing investors to see the annual costs on a yearly basis – including, critically, the actual size of any entry charge in the first year rather than a much smaller amount spread over several years – such a change will also ensure alignment with the cost disclosures under MiFID II.
- (2) Taking into consideration the requirements of Article 8(3)(f) of the PRIIPs Regulation regarding the effects of costs on the investment, we are not suggesting changes to the first cost table. We repeatedly argued that linear products should not produce performance scenarios. Given that such products would not have any performance scenarios to draw upon, we see value in a standardised growth rate. In such instances and based on the current Level-1 requirements, a growth assumption of 3% could be reasonable.

**10. Do you have any comments on the proposed approaches in relation to the analysis and proposals in this section?**

We take note of the high importance of the UCITS KIID framework in terms of properly disclosing information to investors, given that the ESAs are considering incorporating over 15 (of a total of 39) articles of the UCITS KIID Regulation (Regulation 583/2010) into the PRIIPs Level-2 Regulation.

The sheer number of articles identified by the ESAs again showcases that the shift from the UCITS KIID to the PRIIP KID is no trivial matter. Given the ESAs' very high-level and preliminary analysis, we expect that the proposed additions to the PRIIPs delegated acts will not be "targeted" but rather large in size. As the industry will not be able to see and comment on any of the detailed "UCITS additions" to the PRIIPs framework until they are sent to the co-legislators for approval early next year, we again must stress that this highlights the need to reinstate the original sequencing as laid out in Article 33 of the Level-1 PRIIPs Regulation in order to produce a coherent and well-staged process that would result in the phasing-out of the UCITS KIID.

We are astonished by the ESAs' presumption on page 30 that should UCITS be required to provide a PRIIPs KID to retail investors, the UCITS KIID may still be provided to professional investors. This again

highlights that the phasing-out of the UCITS KIID is not a technical or trivial matter, that it requires the decision of the European co-legislators on many of aspects and that more time than a couple of weeks is needed to consider these issues. In the case of a phasing-out of the UCITS KIID after the successful resolution of all current drawbacks (i.e. a PRIIP KID version 2), EFAMA disagrees with continuing to provide a UCITS KIID to professional investor, for many reasons:

- The KIID is not a useful document for professional investors, who are often in need of, and capable of digesting more complex information. Much more targeted information is made available to them as part of their ongoing business relationship and/or at their individual request.
- The production of both a PRIIP KID and a UCITS KIID will require the expenditure of additional and unwarranted resources by the fund industry to produce a document of little or no use for professional investors.
- In cases where professional share classes are also open to retail investors, a situation will again arise where, for the same fund, there are two different key information documents. This will cause significant confusion for investors and will, operationally, be unfeasible to implement for firms. We understand that the underlying reason for this consultation was to avoid providing diverging information to investors. The ESAs proposal would perpetuate this scenario.
- Last but not least, if the UCITS KIID is not fully phased out, the ESAs' assessment to delete Article 12-14 of the Delegated Regulation regarding multi-option PRIIPs (MOPs) becomes null and void as certain products would still produce only UCITS data, which would then have to be accepted by MOP producers.

Overall, these detailed comments highlight that more thinking around the potential UCITS transition is needed and that the current timeframe does not allow sufficient input from the co-legislators for a seamless transition between the two regimes. This again highlights the need for a proper Level-1 review as laid out in the PRIIPs Regulation.

**11. Do you have any comments on the preliminary assessment of costs of benefits?**

**12. Are you able to provide information on the costs of including information on past performance for different types of PRIIPs?**

**13. Are there significant benefits or costs you are aware of that have not been addressed?**

The switch from the UCITS KIID to the PRIIP KID will carry substantial costs for the fund industry that are in no way related to added benefits to the end investors. This is exacerbated by the Commission's and ESAs' rushed timeline to make this shift happen before the end of 2019. Furthermore, repeated changes will also erode consumer confidence in the PRIIP KID.

As many IT budgets have already been decided for the next calendar year (largely related to other essential regulatory-related work), such large-scale IT projects will consume unnecessary amounts of money and resources. Furthermore, given that many UCITS ManCos and AIFMs have delegated the production of the UCITS KIID to third parties, we are hearing that there is already a bottleneck for all

of these service providers to manage successfully the transition to the PRIIP KID for a number of UCITS and AIFs by 2019.

The costs associated with the production of the transaction costs disclosures, based on currently flawed 'arrival price' methodology (see below), also clearly outweigh the benefits to investors. While stressing that we support the disclosures of transaction costs, a revised methodology is needed that provides fair, clear, non-misleading and consistent cost information to investors, while keeping in mind the overall reasonableness and proportionality of the system and that 100% accuracy, in particular regarding implicit costs, is not achievable via any method chosen.

Moreover, rushed inclusion of past performance in addition to performance scenarios would also impact information on investment options in MOPs, meaning that the standards for delivery of data to insurance companies would need to be adapted. MOP providers would need to adapt their KID set-up processes shortly after introduction of the PRIIPs KIDs, and the forthcoming full PRIIPs review will probably entail further changes to the information requirements.

The situation is not made easier by the fact that there are many unresolved questions after having gone through the ESAs' consultation that make contingency planning for the "targeted" amendments even harder.

**ADDITIONAL COMMENTS**

As stated in our General Comments, EFAMA is disappointed that the ESAs are focusing this consultation only on essentially performance scenarios while there are other issues that need to be tackled as well to ensure that retail investors are not provided with misleading information. The most important issues relate to (i) the methodology used to calculate transaction costs and (ii) how cost information is presented to investors as a reduction-in-yield figure.

***Transaction cost methodology***

When drafting the PRIIPs Regulation (and MiFID II) the co-legislators decided to reconsider (i) what should be considered a cost and (ii) how it must be disclosed to clients on an ex-ante basis.<sup>5</sup> This was a fundamental change to the previous MiFID I/UCITS KIID approach.<sup>6</sup> The “all costs” figure now includes the ex-ante disclosure of transaction costs (and performance fees).

Transaction costs consist of “explicit” costs (such as broker commissions, transaction taxes, etc.) and “implicit” costs. While there is no disagreement over what constitutes explicit costs, it was never fully clear how to calculate the implicit cost element. MiFID II tried to provide further clarity by stating that “underlying market risks” (i.e. market movements) should not be considered a cost.<sup>7</sup>

Ignoring this essential clarification, the ESAs designed a completely new and complex approach (in the course of the Level-2 implementation process) on how to estimate these implicit costs, the “arrival price” methodology.<sup>8</sup> As EFAMA has consistently pointed out from the outset, this methodology contains a systematic flaw. In essence, the ESAs decided that when calculating transaction costs, market movements (also called “slippage” – i.e. the time between the order and its execution) should be considered a cost and should be added to the market spread. Therefore, any movement of the market between the time of the order and the time of the execution (thereby capturing market risk) is to be considered a “cost” to clients. The PRIIP KID therefore regards such implicit costs, that mostly

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<sup>5</sup> Specifically:

- PRIIPs Regulation Article 8(3)(f) states that the costs associated with the investment comprising both direct and indirect costs must be disclosed; and
- MiFID Article 24(4)(c) and IDD Article 29 (1) (c) state that all costs and charges in connection with the investment service and the financial instrument (which are not caused by the occurrence of underlying market risk) must be disclosed.

<sup>6</sup> The UCITS KIID already provides an all-inclusive cost figure (called the “ongoing cost figure” or OCF). At the time of its inception and in line with the (at the time) applicable MiFID I regime, the co-legislators consciously decided against the disclosure of costs that are hard to predict on an ex-ante basis (such as performance fees and transaction costs). The simple reason for their exclusion was that such costs are highly dependent on unknown future factors such as the performance of the fund and overall market conditions. Also, no standards existed to estimate such costs. Up until now fund investors were informed about these costs only on an ex-post basis through the fund’s annual reports.

<sup>7</sup> MiFID Article 24(4)(c). Compounding this issue is that despite MiFID rules referring to costs “not caused by the occurrence of underlying market risk”, ESMA’s Q&As state that firms may comply with MiFID requirements by using PRIIPs cost methodology, which includes market risk. So, not only may figures not be comparable due to the different data points used by different managers under PRIIPs rules, some figures may be different as firms capture only the market spread and not “slippage” while following the MiFID Level-1 rules.

<sup>8</sup> To be precise, this model has been developed for funds operating for more than three years. An intermediate methodology called “new PRIIPs” exists for funds that have operated for less than three years.

capture a measure of the best-execution of a trade, as an explicit cost to investors and equates them to all other types of costs (such as management fees) incurred by investors.

This methodology results in consistently under- or overestimating transaction costs. The first is particularly relevant if the fund manager executes trades in opposing moving markets (i.e. sells in an upward market and vice versa). This behaviour automatically results in negative transaction costs, which leads to highly misleading disclosures for investors. Funds displaying overall negative transaction costs (see example below) are the most visible outliers of this systemic flaw, but incorrect costs are captured for each single transaction being recorded for each fund.

This exposes another flaw of the arrival price methodology, as it also assumes that the same high level of transparency (i.e. availability of price data) inherent in some liquid equity markets exists for all other financial markets. This is not the case. Due to the less transparent nature of trading in, for example, the bond markets or less liquid markets, it is much more difficult to discover the necessary arrival prices. MiFID II and MiFIR seek to increase transparency in the non-equity markets through extensive changes to the EU's market structures, but these changes have only become (partly) applicable from 03 January 2018 onwards and will take years to take full effect.

In the meantime, information needed for the PRIIPs transaction cost calculation is not available, inappropriate or very hard and expensive to come by. The very theoretical and analytical nature of the methodology requires the development of extensive operational procedures and controls that result in significant costs for all fund managers, but which are especially hard to bear for smaller companies that cannot leverage economies of scale. As can be seen from our examples below, these costs are not proportional to the very limited added value of the information for the end investors, when other methods can provide more realistic estimates for much less cost.

Overall, evidence gathered by EFAMA made it clear that the current "arrival price" methodology is not fit for purpose – due to the impact of market movements in the overall cost figure – and is not providing fair, clear and non-misleading information to retail investors.

The reason for this is that the underlying slippage calculations are influenced by the trading strategy that a fund manager employs. For example, it is possible for a fund manager to submit a limit order at the market open for execution once the stock reaches a specific price later in the day. Alternatively, the fund manager can wait until the stock price has moved to the desired level before submitting a market order for immediate execution. In both cases, the execution price may be identical but in slippage terms the orders will look very different as the slippage cost measurement of the first strategy will include more market movement, despite the same economic outcome.

### ***Proposed solution***

We understand the co-legislators' and the ESAs' intention to capture implicit transaction cost elements, beside the more easily accountable explicit ones. However, changes must urgently be made to address these essential faults.

The aim of a revised methodology should be to create a system that provides fair, clear, non-misleading and consistent cost information to investors, while keeping in mind the overall reasonableness and

proportionality of the system and that 100% accuracy, in particular regarding implicit costs, is not achievable via any method chosen.

With this in mind, we believe that a “hybrid approach” of the two existing methodologies would be the best way forward, as such a system would accommodate different asset classes and markets while recognising that the degree of transparency in the capital markets is evolving as the MiFID II/MiFIR transparency requirements bed in. Furthermore, such an approach would re-instate the attended alignment between the PRIIPs, MiFID II and IDD transaction cost disclosures, which was lost in the PRIIPs Level-2 discussions.

This would require a two-step approach:

(1) Change the time reference of the arrival price calculation

First of all, the reference time of the arrival price calculation needs to be changed from the time of order transmission to the time of execution. This requires only a very select deletion to para. 14 of the Delegated Regulation's Annex VI<sup>9</sup>:

(14) The arrival price shall be determined as the mid-market price of the investment ~~at the time when the order to transact is transmitted to another person. For orders that are transacted on a day that is not the day that the order was originally transmitted to another person, the arrival price shall be determined as the opening price of the investment on the day of the transaction or, where the opening price is not available, the previous closing price. Where a price is not available at the time when the order to transact is transmitted to another person (due to the order initiated outside market opening hours or in over the counter markets where there is no transparency of intra-day prices for example), the arrival price shall be determined as the opening price on the day of the transaction or, where the opening price is not available, the previous closing price. Where an order is executed without being transmitted to another person, the arrival price shall be determined as the mid-market price of the investment at the time~~ when the transaction was executed.

This change would immediately bring about crucial alignment between the PRIIPs disclosures, on one hand, with MiFID II (and IDD) transaction cost disclosures, on the other. It would therefore ensure that there is only one calculation methodology (resulting in one coherent cost disclosure to investors) across these paramount pieces of EU legislation. Furthermore, as some firms already collect mid-market prices at the time of order execution for best execution purposes, this would not only ensure that the market data used for cost calculation are more reliable, but it would also create important synergies in terms of data collection.

(2) Use the “new PRIIPs” methodology as a complimentary solution

Recent experience with the current ‘arrival price’ methodology has shown that reliable price data is available only in liquid markets for some asset classes. Also, the current fall-back solution of “arrival price” methodology using same day opening or previous day closing prices is not leading to reliable results due to the significant bias by the market movement on a trading day. Therefore, a

<sup>9</sup> Following these changes, para. 15 would need to be adapted accordingly as well.

complementary solution should be put in place that allows averaging of price data in the absence of reliable intraday prices. It is essential for less liquid, OTC or other asset classes where the 'arrival price' methodology does not produce sufficiently accurate results.

This complementary solution could be based on the existing "new PRIIPs" methodology. In essence, the revised method would be based on average observations of half the bid-ask spreads in certain assets/asset classes, which would then be multiplied by the actual fund turnover in the relevant asset class. This approach would also facilitate standardised observations of bid-ask spreads by way of spread tables.

### *(3) Redefine transaction cost calculation for real assets*

Real estate and other real assets such as infrastructure investments are currently treated as "other assets" for the purpose of transaction cost calculation. They are also subject to the "arrival price" methodology, with the peculiarity that arrival price is calculated as "the previous independent valuation price of the asset, adjusted for market movements, where appropriate, using an appropriate benchmark index".<sup>10</sup>

This provision does not account for the market realities. The price of e.g. real estate is subject to bilateral negotiations between the buyer and the seller and is not assessable against any kind of price index. More importantly, the price or valuation of the asset itself is not in any way relevant for transaction cost calculations, since there are no implicit costs hidden in the price. All costs associated with transactions in real assets are explicitly charged and, thus, are fully known by the fund and are already disclosed in the fund's annual report. They include, in particular, notary and brokerage fees and taxes for real estate transfer. Thus, costs of transactions in real assets should be calculated by summing identifiable cost items directly associated with a transaction.

### *Costs on a Reduction-In-Yield basis are too difficult to understand for retail investors*

The concept of the RIY (reduction-in-yield) currently being employed to disclose product costs to retail investors is too complex. The fact that the costs include a time horizon and a yield represents a new type of theoretic disclosure that clients have not generally been familiar with to date. Its complexity significantly increases the risk that it is at best ignored by investors and that at worst it is misunderstood and completely the interpretation is taken of the information. Also, MiFID II (and IDD) do not require the disclosure of costs in an RIY format.

While we understand the reasoning and the (theoretical) added value of the RIY concept, consumers should be provided with a cost disclosure which is more understandable and with which they are more familiar. Both disclosures can be given via the separate cost tables currently required in the PRIIP KID.

Moreover, the costs currently disclosed are theoretical. Investors should also be given a product's actual costs without any assumptions about length of holding period or possible returns.

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<sup>10</sup> Cf para. 19 (a) (i) and (b) (i) of the Delegated Regulation's Annex VI.

Table 1 (current cost disclosure exclusively using RIY)

<b>Investment: € 10,000</b>			
	<b>If you cash in after 1 year</b>	<b>If you cash in after 2 years</b>	<b>If you cash in after 3 years (recommended)</b>
<b>Total costs</b>	€ 202	€ 311	€ 427
<b>Impact on return (RIY) per year</b>	2.02 %	1.50 %	1.33 %

Table 2 (current cost disclosure exclusively using RIY)

<b>This table shows the impact on return per year</b>			
<b>One-off costs</b>	Entry costs	0.34 %	The impact of the costs you pay when entering your investment. This is the most you will pay and you could pay less.
<b>Ongoing costs</b>	Portfolio transaction costs	-0.04 %	The impact of the costs of buying and selling underlying investments for the Fund.
	Other ongoing costs	1.03 %	The impact of the costs that we take each year for managing your investments.

1. The investor may believe that his entry costs are 0.34% while in reality he will pay 1% ; 0.34% correspond to 1% amortized over 3 years in case he stays invested for 3 years.
2. The investor made to believe that he will pay 1.03% per year while this 1.03% is based on an assumption that the product will have a return of 2.65% per year and that the investor will hold the product for 3 years; the real ongoing costs will of course be different (and maybe radically different). Besides, difficult to compare with another investment.

***Proposed solution***

Our proposal is to offer the investor the opportunity to see the costs in a clear and understandable way, by adding a column showing actual fees in the second table. Table 1 remains unchanged.

Table 2

<b>This table shows the annual fees taken from your investment</b>			
<b>One-off costs</b>	Entry costs	<b>1 %</b>	The costs you pay only when entering your investment. This is the most you will pay, and you could pay less.
	Portfolio transaction costs	<b>-0.04 %</b>	The costs each year of buying and selling underlying investments for the fund.

Ongoing costs	Other ongoing costs	1 %	The costs that we take each year for managing your investments [, <b>which include amounts paid to your adviser or distributor</b> ].
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Brussels, 6 December 2018

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