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PRIIPs and MiFID2 costs and charges

Compliance cross-check of the new disclosure obligations

Presented by MACFARLANES

Welcome & Introduction

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Interaction of PRIIPs and MiFID 2

January 2018 – PRIIPs and MiFID 2 came into force.

Mutual objective - to strengthen investor protection and improve transparency in the market.

Firms not strictly subject to PRIIPs may not have escaped entirely with the MiFID 2 costs and charges calculations now aligned to the methodology in PRIIPs.

PRIIPs Regulation – when does it apply?

Investments where, “*regardless of the legal form, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets, which are not directly purchased by the retail investors*”.

Applies to PRIIPs that are “*made available*” to retail investors. If any retail investor can subscribe for an interest in the PRIIP, it has been made available to retail investors.

No reverse solicitation exemption.

A uniform three-page standard key information document (KID) will be required in all instances.

Products specifically restricted from investment by EEA retail investors will not be subject to the regime – ensure proper paper trail.

PRIIPs – who does it apply to?

The definition of “retail investor” is aligned to the client categorisations under MiFID, and is therefore, unexpectedly broad.

It encompasses:

- High-net-worth individuals;
- Sophisticated individuals (such as staff, family and friends of the Manager); and
- Certain public authorities (e.g. municipalities and local authorities).

Under MiFID, investors that are not automatically considered “per se professional clients” must meet certain requirements set out in two tests (a qualitative test and a quantitative test) in order to elect to be able to be treated as “elective professional clients”, and not as retail investors.

PRIIPs – key requirements

The Regulation aims to help retail investors better understand and compare key features, risks, rewards and costs of PRIIPs by providing them with a KID prior to investment.

The structure and content of the KID is prescribed in the legislation but there are some potentially more challenging aspects:

- performance scenarios;
- costs; and
- risk indicators.

PRIIPs – performance scenarios

Future expected performance, i.e., average return per year after costs, should be estimated and presented in four scenarios (each determined in accordance with a prescribed methodology):

- unfavourable;
- moderate;
- favourable; and
- stress.

These scenarios must be presented at various points of the recommended holding period for a product, generally: one year, half the recommended holding period, and at the recommended holding period.

PRIIPs - costs

All direct and indirect costs (one off, on-going and incidental) incurred by the investor must be included, and presented by their impact on returns averaged over the holding period.

This includes transaction costs (calculated on an annualised basis on an average of the costs over the previous three years), including implied costs such as opportunity costs.

Transaction costs must be calculated according to a prescribed methodology in Annex VI of the PRIIPs RTS.

PRIIPs – risk indicator

Managers will need to assign a “summary risk indicator” to the PRIIP by giving it a number on a scale from 1 (being the lowest risk) and 7 (being the highest risk). The methodology to determine the relevant number is based on onerous market risk and credit risk calculations.

It is likely that many hedge funds will be assigned a summary risk indicator of 7.

PRIIPs – Impact on manufacturers/distributors

Manufacturers - the obligation to produce a KID falls to the manufacturer of the PRIIP, including Managers, if the PRIIP is made available to retail investors in the EEA. Managers will also be indirectly impacted where a retail investor's investment is in a fund, which is in turn investing in the Manager's fund (a fund of funds). In these circumstances, the provider of the fund of funds will likely require detailed information from the Manager.

Distributors – Distributors of PRIIPs are required to provide the KID to retail investors. Distributors will be persons advising or selling the product, which in certain circumstances may be the same entity as the manufacturer.

Likely applicability - sales to high-net-worth or staff and family of the Manager either directly or through the Manager's administrator; where a Manager has European distributors (e.g. private wealth managers) selling the fund to retail investors, or in relation to sales through a third-party distribution platform.

PRIIPs – how will information be shared across distribution networks in the EU?

An industry-agreed template has been produced, and published by the European Fund and Asset Management Association.

The European PRIIPs Template (EPT) is freely available and is being widely used across the industry to facilitate the necessary data exchange to support the required disclosures.

There are also a number of third-party vendors providing data management and reporting solutions, including facilitating the exchange of potentially large uploads of data to distributors.

PRIIPs – fair, clear and not misleading

One of the greatest challenges for Managers is balancing compliance with the strict, prescriptive details of the Regulation, with the requirement to produce a KID that is fair, clear and not misleading.

Since the AIMA paper, the FCA published a statement regarding the publication of explanatory materials if they are concerned figures (performance scenarios) are misleading.

MiFID 2 – costs and charges - key requirements

The MiFID II costs and charges disclosure obligations:

- Provide the following disclosures to "clients" of the Manager:
  - Prior to investment services being provided, disclosure of aggregated expected costs and charges based on actually incurred costs, or where this isn't available, reasonably estimates *(ex-ante)*; and
  - Annual personalised disclosure of aggregated actual costs and charges incurred *(ex-post)*.
- Disclosures provided on an aggregated basis in relation to:
  - All costs and associated charges charged by the firm for the investment/ancillary services provided to the client; and
  - All costs and associated charges associated with the manufacturing and managing of financial instruments
- Expressed as cash amounts and as a percentage
- Costs and associated charges are:
  - One-off charges (e.g. fees paid to the firm at the beginning or end of the service provision)
  - Ongoing charges (e.g. management fees, advisory fees, custody fees)
  - Transaction costs (e.g. broker commissions, FX costs, transactions tax)
  - Ancillary costs (e.g. research costs, custody costs)
  - Incidental costs (e.g. performance fees)

MiFID 2 – methodology to calculate transaction costs

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- ESMA has mandated use of the PRIIPs methodology for calculating transaction costs (Annex VI of the PRIIPs RTS) for:
    - Costs disclosures relating to investment/ancillary services; and
    - Costs disclosures relating to financial instruments.
- PRIIPs methodology ensures both explicit and implicit transaction costs are captured:
    - Incidental costs captured by identifying the mid-market price at the time an order ("arrival price") is placed as against the net realised execution price
- ESMA does clarify that if the costs of using the PRIIPs calculation are disproportionate then Managers may use an alternative approach and include a clear explanation of the calculation methods.

MiFID 2 – methodology – “arrival price”

- “Arrival price” may not be a relevant trading benchmark and may lead to potentially misleading cost calculations
  - A difficult trade-off between compliance with the prescriptive calculation methods and a desire to achieve accurate and clear disclosures.
  - Consider including additional explanatory material or cross-reference to other cost calculation documents, based on more accurate measurements.
- “Arrival price” may be difficult to determine for instruments with low liquidity and transparency.
- Managers will need to document a reasonable approach.

MiFID 2 – timing and frequency of disclosure

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- **Ex-ante costs and charges** disclosures must be provided prior to the provision of the relevant services.
  - Treatment of existing clients?
  - Changes after 3 January 2018
- **Ex-post costs and charges disclosures** must be provided to clients on a personalised basis, at least annually.
  - Managers should ensure that where the reporting period is less than a year:
    - the calculation is for a full 12 month period; and
    - the calculation is pro-rated, with a clear explanation of the reporting period.

MiFID 2 – Offshore affiliates

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Where offshore affiliates are involved in manufacturing, or co-manufacturing products sold to European clients, the Manager should obtain the relevant information from those entities, to include this in their calculations, or in their onward data sharing to relevant parties.

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