



No let-up on costs and charges

Chapter 4

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No let-up on costs and charges

In last year’s report¹, we described how costs and charges were at the top of the reform agenda in the investment industry. Little has changed in 2018.

Regulators around the globe continue to pursue simple and meaningful cost disclosures for funds, which remain elusive.

Meanwhile, an increasing number of regulators are also scrutinizing the level of costs and charges, with “closet tracking”, disclosure of benchmarks and performance fees being headline issues.

And the industry’s remuneration practices continue to come under the microscope, with different potential outcomes for asset managers and fund management companies.

¹ <https://home.kpmg.com/uk/en/home/insights/2017/06/evolving-investment-management-regulation-fs.html>

Disclosure of costs is paramount

In **Japan**, the JFSA² introduced in 2017 seven "Principles for Customer-Oriented Business Conduct" (see Chapter 3), among which was a principle of disclosure on fund commission fees. This principle demands that asset managers appropriately manage conflicts of interests, particularly in the case where the distributor receives the payment of a commission fee from the product provider. Another principle clarifies that the details of the fee and other costs borne by the customer should be provided so that the customer can understand the fee.

It requires information about third-party payments to be provided to clients. It 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. This shows investors what they indirectly pay for the services they receive, allowing them to understand the total costs and to compare different services and financial instruments.

In **Switzerland**, the introduction of FinSA³ brought in rules on how and when to disclose costs and charges to clients.

Meanwhile, in the **EU** under MiFID II⁴, ESMA⁵ expects the industry to use the methodology in the PRIIP KID⁶ for *ex-ante* costs, which includes implicit market risk. Also, it expects UCITS and other funds not currently subject to the PRIIP KID regulation to provide *ex-ante* transaction costs in line with the methodology for new PRIIPs. This methodology is less problematic than the main PRIIP methodology, but it nevertheless includes (or is silent on) a number of aspects that are causing firms practical difficulties in implementation – for example, the current absence of market data.

...but meaningful costs disclosure remains elusive

MiFID II and PRIIPs are central to the costs and charges push in Europe. But all has not gone smoothly. The transaction cost disclosures have produced some extreme figures that are misleading to investors. Morningstar data shows that hundreds of funds apparently have negative transaction costs, while others appear to have excessively high costs. Asset managers and other experts say the results are down to flawed methodology.

Under MiFID II, managers must provide distributors with transaction cost data that includes estimated implicit costs, the difference in the price when the transaction is executed compared with the price when the transaction order is entered. This can result in negative figures.

“managers must provide distributors with transaction cost data”

In fact, more than 580 funds reported negative transaction costs in January 2018, with 36 funds quoting costs of minus 1 percent or less. The European Fund and Asset Management Association (EFAMA) says the inclusion of implicit costs within transaction cost figures “will at best confuse investors and at worst mislead them”.

Asset managers may need some considerable time before they can provide accurate transaction costs. By early 2019, funds will be able to show actual transaction costs over the previous year, which should give a more accurate representation of costs, but critics say the methodology itself needs to be revised.

ESMA is not convinced that revisions are necessary. Steven Maijor, chair, said in March 2018, “we are ready and willing to look at this issue but [that] we need to see concrete evidence to assess whether these flaws are real. In the absence of any such evidence, we maintain our view that the methodology is sound and that negative transaction cost figures should be extremely rare”.

Fund platforms react to confusion

The MiFID II and PRIIP KID requirements have had a tangible effect on funds. Hargreaves Lansdown, for instance, in January 2018 – just after implementation of the new rules – removed 1,200 ETFs⁷ and 300 closed-ended investment trusts from its platform because they did not comply with the new rules. Hargreaves, the UK’s largest fund supermarket, delisted nearly 100 Europe-domiciled funds and 1,100 funds that are domiciled elsewhere, mainly in the US. It did not expect to reinstate 900 predominantly US-domiciled ETFs and 200 mainly US-registered trusts, as these are unlikely to seek to comply with the new guidelines.

² Japanese Financial Services Agency

³ Financial Services Act

⁴ Markets in Financial Instruments Directive, revised

⁵ European Securities and Markets Authority

⁶ Packaged Retail Investment and Insurance-based Product Key Information Document

⁷ exchange-traded fund

“ impact of fees on fund performance...a significant regulatory topic ”

Similar concerns surfaced around the PRIIPs rules when they came into force in January 2018. The rules are designed to help retail investors understand and compare the key features, risks, rewards and costs of different products through a short document, the KID. However, the scenarios outlining potential returns to investors (stressed, unfavorable, moderate and favorable) are based on five-year performance, which is producing misleading results, says the industry.

In the **UK**, the Association of Investment Companies said it had been inundated by complaints from members that the regulation was forcing them to overstate their performance and understate the risks.

The FCA⁸ responded to the complaints, advising that where a PRIIP manufacturer is concerned that predicted performance may mislead investors, they can provide additional explanatory wording in the KID. Firms selling or advising on PRIIPs could also provide an explanation as part of their communications with clients.

Again, ESMA appears unconvinced that there is an issue with the prescribed methodology, but it is working on further guidance. More generally, a review of the PRIIP KID is scheduled for 31 December 2018, when the European Commission will assess the impact of the regulation.

While the PRIIP KID currently applies only to AIFs⁹ (i.e. non-UCITS¹⁰), EFAMA has repeatedly warned of the issues for UCITS that are the underlying investment components of other PRIIPs. It is also concerned that the rules as currently written should not be extended to standalone UCITS in 2019.

Low tolerance for high fees

The impact of fees on fund performance, particularly on active fund performance, is becoming a significant regulatory topic, with a number of regulators performing assessments.

In **Canada**, regulators completed their investment fund modernization project in 2017, which aimed to ensure that investment fund clients receive comprehensive and transparent information on the cost and performance of their investments. The current project is now focusing on fees and fairness.

In late 2017, a **European** campaign group called on the fund management industry to stop the proliferation of small, expensive funds. The group, Better Finance, found there are 8,700 European funds with assets under management of less than USD 20 million (EUR 17 million), of which a quarter have ongoing charges of 2 percent or more. Among these small funds, 1,200 charge over 2.5 percent and more than 700 charge over 3 percent, it said.

Guillaume Prache, managing director of Better Finance, said: "This is a very important problem as, contrary to common thinking, these small-size funds are often UCITS and are often sold to retail investors without any appropriate warning."

But assessments of the impact of costs are not easy to gauge, as the European Commission and ESMA discovered.

ESMA apologized for errors in its 2017 report on the effect of fees on fund returns. It originally said that active equity fund returns of 15 percent fall to just 3 percent after costs. However, this figure was found to be incorrect due to a number of typographical errors in the report. In fact, sales charges and inflation lowered active equity fund returns by 3 percent – reducing returns from 15.5 percent to 12.2 percent.

The study also shows that the effect of costs on money market funds is larger than for bond funds, which in turn is larger than for equity funds. However, the regulator did not account for these asset class variations when assessing costs across Europe. For example, the study does not consider whether **Dutch** or **Swedish** investors – who are subject to the smallest cost impact on returns – are more likely to invest in equity funds than **Austrian** or **Belgian** investors – who suffer the largest cost impact on returns. In fact, Dutch and Swedish investors have a larger portion of their assets in equity mutual funds than investors in Austria or Belgium, explaining much of the difference in returns highlighted in the study.

The issue was further muddied by the study's inclusion of inflation in its analysis, which is questioned by some in the industry.

ESMA is now carrying out a new larger-scale study into the impact of costs on fund performance. It says the first analysis has helped it develop "initial metrics to analyse the impact of ongoing fees, one-off charges and inflation on the returns of mutual funds."

Meanwhile, in February 2018, the **French** AMF¹¹ published a study on fees charged by French or foreign UCITS distributed in France, based on analysis of information

⁸ Financial Conduct Authority
⁹ alternative investment fund

¹⁰ Undertakings for Collective Investments in Transferable Securities

“ a new larger-scale study into the impact of costs on fund performance ”

found in the funds' key investor information documents (KIIDs) for the financial year 2015 and the disclosed ongoing charges.

The AMF wrote that of the 8,038 funds distributed to the general public, 148 UCITS, representing 0.33 percent of assets under management, disclosed substantially higher charges than their competitors. Among these UCITS, 70 percent had less than EUR 20 million in assets, which likely did not allow them to benefit from economies of scale. In addition, the majority of these funds charged additional fees when their fund manager bought or sold portfolio securities (turnover fees), which increased the level of ongoing charges disclosed in the funds' KIIDs.

The AMF observed that some of these UCITS have since merged or been liquidated, which could be the result of competition from other UCITS that charge lower fees.

In last year's report, we described the interim findings of the **UK** FCA's Asset Management Market Study which uncovered competition issues among platforms, as well as findings of weak price competition and mixed cost control among fund managers. The final report was little changed and the FCA proposed a suite of new rules.

The final rules were issued in April for implementation by 30 September 2018. The boards of fund management companies must include at least two independent directors and appoint someone with direct responsibility for demonstrating value. However, the FCA did not mandate switching to best value share classes and did not introduce an end-date for payments of trail commission to financial advisers.

In July 2017 the FCA said it would explore whether platforms help investors make good investment decisions and whether the investment solutions offer investors value for money. The interim report is expected mid to late 2018.

In **Ireland**, the CBI¹² has included in its 2018 supervisory program a thematic review into practices relating to the charging of performance fees to UCITS. The initial focus is understood to be the calculation of performance fees by administrators and the verification of those amounts by depositaries.

¹¹ Autorité des Marchés Financiers



Also, the CBI is consulting until 29 June 2018 on whether Irish UCITS should be banned from charging performance fees more frequently than once a year. According to the central bank, this requirement would bring the regulator's approach into line with IOSCO¹² recommendations on fees and expenses. Only a small number of Irish UCITS apply performance fees and these funds tend to be aimed at institutional investors.

Closet tracking is still a big deal

The **European** Parliament announced in September 2017 it would conduct a study into closet tracking funds – funds that mirror their underlying indices despite being marketed as actively managed – and potential disclosure failings by UCITS. The parliament's influential Economic and Monetary Affairs Committee commissioned the study, which will be debated by MEPs¹⁴.

ESMA's study in 2016 found that between 5 percent and 15 percent of UCITS equity funds could potentially be closet trackers. Following its probe, ESMA commissioned national regulators to carry out further investigations into the issue.

However, regulators such as **France's** AMF and **Luxembourg's** CSSF¹⁵ found no evidence of closet index funds. The AMF criticized the methodology used by ESMA and said that based on its own analysis there are no French closet trackers. The CSSF said it could not identify any UCITS qualifying as a closet index tracker, apart from "one isolated case".

Better Finance also estimated that roughly 70 of 165 funds suspected of being closet trackers do not disclose benchmark performance and questioned whether they are in breach of EU law. Current regulation requires funds to disclose 10-year performance of their chosen benchmark alongside the 10-year performance of their fund.

The CSSF did note that disclosure in relation to benchmarks could be improved for some of the funds under review and asked the firms concerned "to increase the level of information disclosed in the [KIID] and the sales prospectus".

It is not clear how easy it will be for regulators to make charges of closet tracking stick. The Oslo District Court ruled in January 2018 that a **Norwegian** investment firm did not overcharge investors on three funds. The lawsuit, filed on behalf of 180,000 investors, was the largest class action lawsuit in Norway. Norway's Consumer Council has lodged a formal appeal against the verdict, saying the ruling is not "consumer friendly".

¹² Central Bank of Ireland

¹³ International Organization of Securities Commissions

¹⁴ Member of the European Parliament

¹⁵ Commission de Surveillance du Secteur Financier

“ funds that mirror their underlying indices despite being marketed as actively managed ”

In **Sweden**, a public inquiry published in 2017, urged greater transparency with regard to how active a fund is and tracking errors.

Meanwhile, ESMA’s new study, announced in October 2017, compared active and passive funds. ESMA examined the extent to which active funds beat their benchmarks, and compared active returns against passive products.

The launch of the study followed the publication of the **UK** FCA’s report into asset management, which found that active funds provide poor value for money. As a result of the FCA report, the UK regulator said in March 2018 that asset managers should compensate investors who were overcharged for closet tracking funds. Investment firms must notify clients who may have been overcharged. The FCA also demanded that 64 closet tracker funds – out of 84 suspect funds investigated – must change how they market the funds.

Richard Stobo, who was at the time team leader for investment management at ESMA, said the **European** watchdog is “very aware of the work the FCA did and have been looking at [it] closely”.

The FCA report was disputed by the active fund industry, which criticized the methodology and provided evidence that contradicted the FCA’s findings.

In the **Netherlands**, the Dutch shareholders association said it fully embraced the ESMA probe into fund fees but warned that it must be transparent in order to allow stakeholders to “verify the results”.

The European Commission in June 2017 also published economic analysis suggesting that retail investors should invest in passive funds. The analysis, which was published alongside the Commission’s CMU¹⁶ mid-term review, endorsed efficient markets theory, saying “in effect no other portfolio can have both a higher expected return and lower risk than the total-market portfolio”. Retail investors may therefore be “partially misguided” if they attempt to outperform markets via actively-managed funds.

Although the academic analysis is not a policy position paper, fund representatives were concerned that the Commission appeared to be directing investors towards a particular investment type. The **UK** Investment

Association (the IA) and the **German** asset management trade body (the BVI) both took exception to the Commission’s comments. Active and passive strategies both have their merits and “none of them should be in general declared as superior”, said the BVI.

The IA questioned the Commission’s use of the S&P Spiva Scoreboard to support its argument that only a small number of professional investors outperform the market. The IA pointed out that only a tiny proportion of European funds use S&P indices as a benchmark.

The focus in **Hong Kong**, on the other hand, is on minimum fund sizes and challenging fund trustees if performance is persistently low. It is said to be closely following the debate in the UK on “value for money”.

Remuneration still under the microscope

Remuneration is another debate, like closet tracking, which continues to raise the hackles of regulators and industry alike.

In **Europe**, CRD IV¹⁷, which came into force at the start of 2017, includes a cap on bonuses for material risk takers at 100 per cent of fixed salary, or 200 per cent where there is shareholder approval. Interpretation of the application of this requirement varies across Europe, and the **Netherlands** imposes a lower cap. The European Commission said it was considering waiving strict banking remuneration rules for some non-banking groups – including asset managers. It wrote to the European Council and European Parliament, saying it would conduct an impact assessment on allowing rule waivers.

However, in January 2018, this process hit a stumbling block after the waiver encountered strong resistance from **Germany**. During an initial discussion of the legislation between EU member states, Germany said the decision to exempt asset managers should be reconsidered.

UK-based asset managers affected by the proposed regime tend to operate under MiFID licenses. Many continental European asset managers, on the other hand, provide asset management services from their fund management companies. They fall under the UCITS Directive or AIFMD capital requirements and are not in scope of CRD IV.

¹⁶ Capital Markets Union

¹⁷ Capital Requirements Directive, revised

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