2nd March 2015

Comments by the True and Fair Campaign on the 2014 ESMA Consultation Paper MiFID II/MiFIR (ESMA/2014/1570)

Introduction

The True and Fair Campaign congratulates ESMA on its resolve in sticking to the principles laid out within the original EU text of MIFID rather than allow self-interested and misleading arguments put forward by various trade bodies and fund management groups to lead to a watering down of the original text such as to fragrantly contradict the spirit of the original, pro-consumer intent.

Many investors, whether retail or institutional have lost trust in the financial services industry. MIFID has the ability to dramatically improve transparency and thereby trust in this industry, which should benefit both consumers and the industry over the long-term. It would also serve to make the EU, the gold standard in terms of genuine consumer protection by allowing key conflicts of interest to be substantially reduced and for consumers to be able to compare one financial product with another in terms of overall fees and costs for the first time.

This latter event should lead to increased competition in the industry and bring overall prices down, thereby saving EU savers and investors significant sums over the medium to long term. Our view is that genuine transparency means rather than disclosing some of the various costs and charges in obscure places in an incomprehensible fashion, the likely all-in cost should be shown prior to investing in a prominent place and in a comprehensible format.

Comment on recent publication by The Investment Association (IA) dated 20th February 2015 re cost disclosures

We are extremely concerned about the many false arguments and representations contained within this document and feel it important to bring these fundamental flaws to the attention of ESMA.

The IA's latest proposal re cost disclosure show nine different types of fee, separately rather than added up with some shown per fund unit and some per transaction, making them completely meaningless to

virtually every consumer. Our research in the UK has found that as many as 89% of investors want to see their charges in percentages[1], as well as the actual pounds and pence amounts.

The nine elements contained within the IA document are:

1. The ongoing charges
2. The performance fees
3. The one-off charges
4. The explicit transaction costs
5. The implicit transaction costs
6. Stock lending
7. Repurchase arrangements
8. Financing costs
9. Taxes.

Very importantly, the proposals exclude all the other costs / layers associated with investing – adviser charges, platform charges and the product charges. It is imperative that all fees are shown at the point of

This fragrantly breaches the MiFID II text to "aggregate" all costs or to display costs in a 'comprehensible' manner. The MifidII text is clear and unambiguous – key words underlined:

*'The information about **all costs and charges**, including costs and charges in connection with the investment service and the financial instrument, which are not caused by the occurrence of underlying market risk, **shall be aggregated** to allow the client to understand the overall cost as well as the **cumulative effect on return of the investment**, and where the client so requests, an itemised breakdown'.*

Consumers deserve to be treated fairly and empowered with the tools to make informed investment decisions. More and more consumers are making investment decisions themselves, and often managing the funds for their entire retirement themselves.

They need to know a reasoned estimate of the full cost of their potential investments before, not just after they invest, presented in a way they can understand.

In our view, any reporting of costs and charges should meet these key objectives:

1. **The fewer numbers shown the better. Individual investors are unlikely to understand countless different numbers in differing formats.** For example separating out cost per fund unit with cost per transaction makes it impossible to fulfill the overriding MIFIDII aim to "aggregate" all costs since the two costs cannot be added together as they are not shown in the same format.

   Furthermore, the fund management related costs are just one part of the total annual costs facing consumers, with platform charges, advice charges, wrapper charges often being as substantial as

[1] http://www.trueandfaircampaign.com/wp-content/uploads/2014/03/true-and-fair-campaign-2nd-anniversary-report-legalised-looting-march-2014.pdf

the fund management related charges alone. They all need to be added together to enable consumers to judge the total cost they face and the merits of buying the same product through different channels.

Even the one-off charges should be annualised and added to the other costs to provide one overall number. The easiest way to perform this, would be to take some elements of the FSA's former 'Reduction in Yield' (RIY) which set out to combine initial and ongoing charges into one number.

The RIY was calculated over an assumed 10 year investment horizon. Rather than use an arbitrary fixed investment return, that may be applicable to some investments but not to others, it would be better to simply assume 0, and explain this assumption in the notes. Thus, in practice any initial or final charges would be divided by approximately 10 and added to the other annual charges.

This would make all investment products bought through all investment channels, comparable and enable an all-encompassing headline charge number to be easily displayed prominently. Where, it is clear that the majority of investors will be investing over a different term e.g. if they were to invest in a fixed five year product, than the more appropriate term should be used, with notes explaining why the 10 year term is not being followed.

This would therefore meet the overriding EU objective within the text to 'aggregate' all costs and would also succeed in displaying costs in a 'comprehensible' manner. An example of the headline number together with full underlying detail is shown later.

2. **The costs shown prior to purchase (ex-ante) should contain the same actual or best estimate of costs as those shown to clients after purchase (ex post).** It is clearly highly misleading to not show some costs prior to purchase and then show the same costs to consumers after they have already invested, by which time the investment decision has been made and is unlikely to change.

   The argument that some costs should be excluded from the ex-ante cost as they may be volatile is entirely spurious. This can be simply overcome by 'smoothing' such items of costs over the previous 3 years. This would allow consumers to have a guide to future transaction costs or performance fees based on recent history, rather than these costs being ignored completely. Equally, just showing the formula by which a performance fee is calculated or showing a level of portfolio turnover is completely different from showing actual performance fees or actual transaction costs.

   A system of showing levels of portfolio turnover alone as an indication of costs will be highly misleading as the transaction costs for different assets, and therefore the overall impact will vary enormously.

   It is no defence to say that simply because a cost changes from year to year, it should be artificially hidden. It is better to show all the costs with 95% accuracy than 50% of the costs with 100% accuracy. We completely agree with ESMA that '*These volatile costs should be estimated on a best effort basis*' rather than artificially ignored completely.

In terms of the spreads, we recommend taking the 30 day average spread as at the end of the relevant investment period – this field is available for many securities via independent data providers e.g. Bloomberg.

There cannot be an arbitrary debate as to which costs should be shown to consumers in this 'Ex ante' number, it must be all the costs. The argument that some costs can deliver a higher return and therefore should be excluded is entirely spurious – even if this was true (and the academic evidence[2] says otherwise), the returns are already being shown to investors anyway. Investors need to know the full costs of deriving those returns to allow them to decide whether it is worthwhile investing or not.

3. **In accordance with MifidII the impact of costs and charges should be shown over the course of the investment.** Few investors are aware of the importance of compounding whereby paying high costs, year after year, can decimate long-term returns. The only way to illustrate the impact of such costs is to produce a table showing the impact of ALL charges for a typical investment size, over various periods of time.

   For many years, UK consumers benefited from an 'Effect of Charges Table' showing the impact of charges over time – specifically after one, three, five and ten years. This would not only serve to show consumers the costs over their likely investment period, but enable the costs to be shown in monetary amounts. There is widespread evidence that consumers do not want to see their charges in percentages but in actual amounts.

4. **The important headline cost numbers and the table illustrating the impact of charges over the course of the investment should be shown clearly at the point of sale.** Many consumers will not look at the KIID document so regulators should strongly encourage such information to be prominently displayed at other key places e.g. the relevant summary page on platform websites and the relevant factsheet. Many more consumers look at the factsheet rather than the KIID document prior to purchase.

   Within the 19th December ESMA document it states that '*The aggregated costs and charges should be totaled and expressed both as a cash amount and as a percentage*.' And that '*Information about costs provided on a regular basis during the life of the investment should be based on costs incurred and should be provided on a personalised basis*.' Thus it is imperative that whoever the last in the chain is, provides the full total of the various layers and shows this to customers individually.

   In our view, the easiest way to achieve this is via on-line calculators populated with the various underlying cost and charges data that allows every investor to be given a 'personalised illustration' whereby once they have entered the amount, the product, the length of time anticipated and the assumed investment return, a monetarised cost and return illustration can be made.

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[2] "Shedding Light on 'Invisible' Costs: Trading Costs and Mutual Fund Performance", by Roger Edelen, Richard Evans and Gregory Kadlec, Financial Analysts Journal, Volume 69, Number 1

The ESMA tables are comprehensive and requires no changes in our view. We have combined the various charges within the two tables for simplicity:

Cost items to be disclosed		Examples:
One-off charges	All costs and charges paid at the beginning or at the end of the investment.	Deposit fees, termination fees and switching costs, Front-loaded management fee, structuring fee, distribution fee.
On-going costs and charges	All on-going costs and charges paid by the client.	Management fees, advisory fees, custodian fees, service costs, swap fees, securities lending costs and taxes, financing costs, broker commissions, entry and exit charges paid to the fund manager, platform fees, mark ups (embedded in the transaction price), stamp duty, transactions tax and foreign exchange costs, research costs, performance fees.

It can be argued that there may be duplication of costs since some of the transaction costs may be already reflected in initial charges to reflect the cost of investing/disinvesting. However, the pricing of funds is incredibly complicated with funds priced on a swing price, bid price, creation price or cancellation price to name a few.

It would therefore seem sensible to follow the US definition of Portfolio Turnover Rate and take the lesser of purchases or sales and then apply the full transaction costs on that element encapsulating all taxes, commissions and spread related costs. This would effectively reduce the level of reported transaction costs and allow for the fact that some (though often not all) investors may be paying an extra creation or cancellation levy that serves to reduce the impact of transactions on the fund.

However, it should be noted that a significant amount of transaction costs within a fund that arise from investors joining or leaving a fund are effectively being partly borne by the fund and the remaining investors. This can be proved by an analysis by SCM of 10 FTSE 100 mutual funds of their returns after all charges during calendar 2014 – the difference between their actual performance and their expected performance (the index return less their stated KIID ongoing charge) was 0.28% - this must be a result of the extra costs associated with investors buying or selling units not incorporated in any unit pricing related charges thereby impacting overall returns.

Suggested Layout:

E.g. Fund A, invested via a tax-efficient wrapper, bought through an adviser holding the fund on platform.

Total Costs and Fees – 2.42% Annualised over 10 years	
Fund Manager Related Costs and Charges	
One-off charges: All costs and charges paid at the beginning or at the end of the investment. A 10 year investment period assumed.	• 1% initial fund charge
On-going costs and charges: All on-going costs and charges paid by the client.	• 0.75% pa annual fund management charge • 0.2% pa custody and administration charge • 0.4% pa transaction related costs
Platform/Stockbroker Related Costs and Charges	
One-off charges: All costs and charges paid at the beginning or at the end of the investment. A 10 year investment period assumed.	• 0.3% pa platform related charges
On-going costs and charges - All on-going costs and charges paid by the client.	
Product Related Costs and Charges	
One-off charges: All costs and charges paid at the beginning or at the end of the investment. A 10 year investment period assumed.	
On-going costs and charges: All on-going costs and charges paid by the client.	• 0.25% pa annual product wrapper related charge
Adviser Related Costs and Charges	
One-off charges: All costs and charges paid at the beginning or at the end of the investment. A 10 year investment period assumed.	• 2% initial adviser charge
On-going costs and charges: All on-going costs and charges paid by the client.	• 0.5% annual adviser charge

Illustrative Effect of Charges Table (using example above)

Term of Investment	Assumed Investment to Date	Aggregated costs and charges over investment assuming no underlying investment returns (the impact will be greater if there are positive returns)
1	**£ 15,000**	**£ 810 (5.40% pa)**
3	**£ 15,000**	**£ 1,530 (3.29% pa)**
5	**£ 15,000**	**£ 2,250 (2.83% pa)**
10	**£ 15,000**	**£ 4,050 (2.42% pa)**

Background

The True and Fair Campaign was initiated by the founders of SCM Private, Alan and Gina Miller, in 2012 to raise awareness of the lack of transparency within the UK investment management industry. It has been calling on UK and European politicians, regulators and fund providers to introduce a new true Total Cost of Investing number that would give consumers 100% transparency on all transaction costs, management fees and intermediary fees via a labelling system; as well as full disclosure on where funds are invested**.**

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