



CFA Institute

THE BRAVE NEW WORLD OF PRODUCT GOVERNANCE IN THE EU ASSET MANAGEMENT INDUSTRY

How MiFID II and PRIIPs have modified the rules of
the game for manufacturers and distributors
May 2020



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Results of a membership survey conducted by CFA Institute

May 2020

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1. Executive summary

CFA Institute has conducted a survey of its European membership on how product governance practices in the asset management industry have changed over time and the specific effects major regulatory developments like MiFID II and PRIIPs have had in this respect. The survey was run over the first half of December 2019.

As a prominent global association of investment professionals, CFA Institute wishes to shed light on an increasingly important part of the sector's value chain, at a time when the economics of the industry are being challenged by a crisis of trust, increasing regulation, compressing margins, the rise of low-cost passive instruments, and the encroachment of technology on finance's traditional turf.

We are focusing our research on the nature of the relationship between manufacturers and distributors of investment products in the EU, which has changed over time and also most recently under the pressure of regulatory developments such as MiFID II and PRIIPs. Ultimately, the question asked is whether the process at play permits the creation of valuable products, at competitive prices and distributed to end-investors with enough transparency and meaningful information. In the end, regulators are interested in encouraging a system where investors can make informed decisions that will have an impact on their long-term savings and financial security.

The key ideas developed in this study are as follows:

- MiFID II and PRIIPs are perceived to have had a positive impact on the quality of the relationship between manufacturers and distributors of investment products.
- There is still a problem of consistency in how Member States and firms apply EU directives on investor information and suitability, which does not help investor protection.
- Respondents support the principle of standardisation of investor information through the KID, yet criticise its high level of complexity, which may defeat its intended purpose.
- Cross-border marketing and passporting is perceived to be a positive effect of regulation, yet the lack of harmonisation and local exemptions are making the whole framework more complicated than it is intended to be.
- Respondents favour further centralisation of supervisory powers with ESMA for the monitoring of marketing practices.

- Respondents agree that the PRIIPs KID can be improved, notably by clarifying performance scenarios, reintegrating past performance, and clarifying or simplifying the presentation of costs, including the contentious issue of slippage.
- The situation of outsourcing needs to be analysed as well, since it touches directly upon the very business model of asset management, which is being increasingly strained by rising fixed costs and compressing margins. At the moment, most firms are still choosing to perform internally the operations related to the production of the KID, but this could change with automation over time.

2. Introduction

2.1 CFA Institute's rationale for the study

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organisation is a champion of ethical behaviour in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow. There are more than 170,000 CFA® Charterholders worldwide in 162 markets. CFA Institute has nine offices worldwide and 158 local member societies. For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAINstitute and on Facebook.com/CFAINstitute.

The Advocacy Division is responsible for researching industry developments, policy, and regulatory changes that have the potential to affect how practitioners in the financial markets and investment management industry conduct their activity. We formulate a position on these developments that is always based on our core advocacy principles.

Our Core Advocacy Principles:

1. We work to advance and promote global policies and regulations that serve investor protection over commercial interests.
2. We create content, research, and commentary that seek improved market structures, transparency of corporate reporting, and financial market fairness for all investors.
3. We help create and support the adoption of best practices, laws and regulatory standards that improve and expand investment industry professionalism.

We promote and have a keen interest in investor protection and market integrity, as stipulated in our mission statement. Historically, we have also taken part in debates about performance and costs presentation, clarity, and transparency. In particular, CFA Institute promotes the adoption of GIPS® standards, which are an investment industry standard for calculating and presenting historical investment performance.

Hence our interest in how the investment management value chain has changed over the years. In this specific case, we are exploring how product governance and the relationship between manufacturers and distributors of investment products have been affected by the regulatory developments in the EU over the past 10 years.

CFA Institute has previously reported on the views we hold that investor information rules in particular have gradually become complicated and may be suffering from a lack of consistency across the various regulatory frameworks (PRIIPs, UCITS, MiFID II, AIFMD). We understand the complexity legislators and regulators are facing as these frameworks are developing in parallel to each other. We also acknowledge and agree that these initiatives are all rooted in the idea that investor protection principles need to be safeguarded against past excesses observed in the financial services industry, which have resulted in severe crises and have dented the public's trust in finance professionals. Repairing this trust is of utmost importance and must be a necessary condition if broader EU initiatives like the Capital Markets Union (CMU) are to be successful. Yet, the complication of investor information, we now feel, may be blurring the message to investors and diminishing the benefits from enhanced transparency.

Ultimately, the objective should be for investors to have access to a large array of investment choices priced competitively (i.e., competition forces should be functional) and to trust the information provided to them so that they can confidently make an informed decision. Investors who lack trust consequently resort to the cheapest and what they perceive to be the safest solutions, which does not promote sound risk taking aimed at funding long-term projects. Such short-termism and exclusive focus on costs run contrary to the current objectives stated by the new European Commission, notably on economic policy and financial services.¹

2.2 Survey methodology

CFA Institute set out to survey its members on product governance practices over time and the specific effects major regulatory developments like MiFID II and PRIIPs have had in this respect. Our objective was to ask our member community how product governance, in particular the relationship between manufacturers and distributors of investment products, had evolved since the introduction of MiFID II and PRIIPs. We also wanted their views on investor information requirements (like PRIIPs, UCITS) and the Key Information Document (KID).

¹ See European Parliament, Briefing, *The von der Leyen Commission's priorities for 2019–2024*, January 2020, [https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/646148/EPRS_BRI\(2020\)646148_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/646148/EPRS_BRI(2020)646148_EN.pdf)

The survey was fielded to a representative panel of currently employed CFA Charterholders residing in the EU, including the UK. The target population was determined based on sectors and professions most likely to include people with potential understanding, interest in, and experience with the subject we were addressing.

The survey was sent on 2 December 2019 and closed on 17 December 2019.

Exactly 12,596 individuals received an invitation to participate. Of those, 527 provided useable data, for a total response rate of 5% and a survey completion rate of 94%. The margin of error was +/-4.18%. (See Appendix 1 for a detailed review of the survey's demographics.)

In October 2019, the European Supervisory Authorities (ESAs) released an open consultation paper setting out proposed amendments to Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 (the PRIIPs Delegated Regulation). In cooperation with several CFA Societies[®] and their members, CFA Institute responded to the consultation in January 2020 using the results from this survey as a basis for a number of our responses.²

Limitations of our study

The study focuses on EU rules and practices in general. It does not analyse in any particular depth the specific cases of individual jurisdictions and their local rules or how these jurisdictions apply EU directives sometimes inconsistently—an issue we explore in the survey. For example, in the UK, the Retail Distribution Review (RDR) applied on 31 December 2012 and had a marked impact on how investment products are marketed to UK retail investors. The RDR had a certain influence on how MiFID II was gradually shaped by EU institutions.

² See ESMA, Responses to *Joint consultation concerning amendments to the PRIIPs KID* (section on Responses), 13 January 2020, <https://www.esma.europa.eu/press-news/consultations/joint-consultation-concerning-amendments-priips-kid#TODO>

2.3 Highlights

The highlights and key statistics drawn from this survey are that

- 51% of respondents think that since the introduction of MiFID II, more care is given to product design and marketing to ensure the right products are reaching their target client base. It is worth noting 29% think the relationship between manufacturers and distributors presents flaws in terms of investor protection.
- 41% of respondents think MiFID II has improved the understanding distributors and advisors have of the investment products they market, thanks to more effective communication with the product manufacturers. However, 37% see no change and 22% still think distributors and advisors have a poor level of understanding.
- 57% of respondents think the administrative process required to assess an investor's suitability prior to making an investment has become too complicated and should be simplified or clarified. It is worth noting 30% think a unique form should be used for MIFID II and PRIIPs requirements on suitability assessment.
- 54% of respondents think investors obtain enough information, yet they think these investors are probably struggling to understand the information because of its complexity.
- 57% of respondents think the EU marketing rules are partially effective for the efficient cross-distribution of investment products across the Union. They say partially because standards remain inconsistent across jurisdictions as EU directives are being applied in different ways, geographically as well as between retail and professional clients.
- 69% of respondents agree the European Securities and Markets Authority (ESMA) should be granted more powers to oversee the cross-distribution of investment products across the EU.
- 52% of respondents think the PRIIPs Regulation (KID) and UCITS Regulation (KIID) frameworks are partially successful, as they have improved information consistency across products and providers, but there remain large variations in the quality and standardisation of information provided. However, 43% think the frameworks have failed to improve investor protection because of their complication.
- 31% of respondents think the PRIIPs KID performance scenarios are not easily understandable for the majority of investors, 24% think the Reduction-In-Yield (RIY) cost

approach in the KID is not intelligible and difficult to compare and 19% think past performance information is missing.

- 54% of respondents reported that their firm kept the entire KID production process in-house, thereby not using outsourcing providers, whereas 28% reported outsourcing both calculation and formatting processes to external providers.
- 53% of respondents completely agree or somewhat agree the PRIIPs KID and UCITS KIID formats should be harmonised, whereas 10% disagree.
- 50% of respondents think the KID should feature past performance as well as performance scenarios, but 38% feel only past performance should feature.
- 47% of respondents seem to favour the idea that slippage represents market risk rather than a cost to investors. Whereas 36% think slippage is a transaction cost that should be reported, 34% disagree. Thus, the industry is showing hesitancy regarding the complex question of how to treat transaction costs in general and slippage in particular. The high level of unsure and neutral responses may indicate the industry in general is not set on this question. Further work by industry and regulators could be warranted in this regard to reach a meaningful consensus.

3. What does the product governance framework entail?

In the European regulatory context and throughout this document, product governance is understood as the dynamic relationship between manufacturers of investment products and distributors of these products to end investors (including advisors).

The key EU regulatory texts that provide references, scope, definitions, rules, and guidance on product governance are

- Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (MiFID II) (see Article 16 – Organisational requirements);
- Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations, and the rules applicable to the provision or reception of fees, commissions or any monetary or nonmonetary benefits (MiFID II Delegated Directive) (see Recital 15 and Chapter III – Product governance requirements); and
- ESMA Guidelines on MiFID II product governance requirements, 05/02/2018 | ESMA35-43-620 (ESMA Guidelines).

The following regulatory texts specifically concern the standardisation of presale investor information documents, imposing on investment management firms the nature, format and detailed calculation methods for the various disclosure requirements:

- MiFID II. See Article 24 – General principles and information to clients.
- Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on Key Information Documents for packaged retail and insurance-based investment products (PRIIPs).
- Commission Delegated Regulation (EU) 2017/653 of 8 March 2017, supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council on Key Information Documents for packaged retail and insurance-based investment

products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of Key Information Documents, and the conditions for fulfilling the requirement to provide such documents (PRIIPs KID Delegated Regulation). See the Annexes to the Delegated Regulation for the detailed guidelines to the KID.

- Commission Regulation (EU) 583/2010 of 1 July 2010, implementing Directive 2009/65/EC of the European Parliament and European Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website (UCITS KIID Regulation).

Finally, the following regulatory texts are aimed at mandating how firms should assess the suitability and appropriateness of an investment product or advice:

- MiFID II, Article 25 – Assessment of suitability and appropriateness and reporting to clients.
- Commission Delegated Regulation (EU) 2017/565 of 25 April 2016, supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms (MiFID II Delegated Regulation). (See Article 54 – Assessment of suitability and suitability reports and Article 55 – Provisions common to the assessment of suitability or appropriateness.)

The MiFID II Delegated Directive and ESMA Guidelines use the following definitions:

Investment product means a financial instrument (within the meaning of Article 4(1)(15) of MiFID II) or a structured deposit (within the meaning of Article 4(1)(43) of MiFID II).

Manufacturer means a firm that manufactures an investment product, including the creation, development, issuance, or design of that product, including when advising corporate issuers on the launch of a new product.

Distributor means a firm that offers, recommends or sells an investment product and service to a client.

In this document, CFA Institute focuses on the product governance practices in the investment management industry. We therefore do not take a particular view on corporate finance or investment banking.

In practice, product governance entails the following sequential two-way operations:

1. The design of an investment product by an investment firm (including the conceptual idea, the proposed investment universe and process, the risk characteristics, and the definition of the target client market).
2. The choice of a distributing firm and the contractual provisions of the legal agreement, stipulating the obligations of the parties.
3. The ongoing communication between the manufacturer and the distributor to ensure the latter properly understands how to sell the product and to whom (the target market), using the technical details provided by the former (target market, appropriateness, suitability, restrictions, costs, and charges).

Of note, the European MiFID Template (EMT)³ is the standardised information document that codifies how the manufacturer communicates the relevant details of any investment product to the distributor who will market it to the target client market.

4. The actual act of marketing, selling, or advising operated by the distributor or advisor towards the target market.

Of note, the PRIIPs KID (or UCITS KIID) is the standardised information document any prospective retail investor must receive from the distributor about the investment product prior to any sale.

Also of note, the MiFID suitability assessment framework: “The assessment of suitability is one of the key requirements for investor protection in the MiFID II framework. It applies to the provision of investment advice (whether independent or not) and portfolio management.”

5. The feedback loop between the distributor and the manufacturer, a step meant to verify that marketing has taken place according to the technical specifications and to the appropriate target market. The ultimate objective is to guard against the risk of mis-selling and to help the clients make an informed investment decision.

³ See FinDatEx, *EMT V3*, <https://www.findatex.eu/work-in-progress>

4. How series of historical regulatory developments have shaped product governance and investor information rules in the EU

Product governance and investor information rules are the result of a series of regulatory developments that have taken place at different times and under different impetuses since the early 2010s. In part, this legislative history explains why the current situation appears patchy and inconsistent in some respects.

In this paper, we focus our attention on investor information rules that pertain to how investment management firms report or disclose information to investors. We are not considering the world of regulatory reporting, whereby investment management firms must report information to the EU's local regulators, the National Competent Authorities (the NCAs).

Four major regulatory frameworks are concerned in varying degrees with product governance and investor reporting:

MiFID

The second instalment of the EU Directive on markets in financial instruments (Directive 2014/65/EU, or MiFID II) applied on 3 January 2018. It introduced a significantly strengthened framework for the governance of investment products, with a focus on their distribution to retail and professional investors in the EU. It also established a shared responsibility between manufacturers and distributors for the suitability and appropriateness of investment products, required that manufacturers define each product's target market and harmonised the required level of transparency on costs and charges of investment products.

PRIIPs

In parallel, the EU Regulation on Key Information Documents for packaged retail and insurance-based investment products (Regulation (EU) No 1286/2014 or PRIIPs) applied on 1 January 2018. It introduced a highly prescriptive and harmonised investor information format—the PRIIPs Key Information Document (KID)—made compulsory for all investment products marketed to retail investors.

UCITS

As regards investment funds inherently designed for retail distribution, investor information rules had already been in application since June 2011 and the fourth instalment of the EU Directive on undertakings for the collective investment in transferable securities (Directive 2009/65/EC or UCITS IV). Specifically, Commission Regulation (EU) No 583/2010 and a series of Level 3 measures (Guidance) from the ESMA provided the details necessary to produce and publish the Key Investor Information Document (KIID).

AIFMD

Finally, the Alternative Investment Fund Managers Directive (Directive 2011/61/EU or AIFMD) applied in July 2013 and deals with managers of alternative funds (AIFs, which are sophisticated strategies that may not comply with UCITS rules) primarily marketed to professional investors. By definition, the investor information rules under AIFMD are lighter; but to measure the buildup of systemic risk in the market, AIFMD sets more stringent obligations for reporting to regulators.

Together, MiFID II and PRIIPs have had a significant impact on how investment firms develop products, market them to various audiences, and then report to investors on how products have performed and what they have cost them. Harmonisation inevitably interferes with industry practices, which have to grapple with a wide array of different strategies, approaches, and reporting standards.

5. What complexities are investment managers facing?

Product governance has become an increasingly complex part of investment management's value chain.

Here are the themes and issues we have endeavoured to explore in this report and through our membership survey:

- **The chain of responsibilities between the manufacturer and the distributor.** Understanding in practical ways the actual level of responsibility of the manufacturer and that of the distributor of investment products. Who is responsible for what? Are distributors sufficiently trained on the strategies? Do distributors know the end clients well enough? Are manufacturers sufficiently aware of the characteristics of the investor markets they target? Are ethics levels aligned?
- **The application of directives related to retail distribution across Member States remains inconsistent.** The concept of retail distribution in itself is complex in the world of AIFMD, as each jurisdiction has its own rules and exemptions (including private placement regimes) to allow or prevent distribution of non-UCITS vehicles to retail investors. This creates a conundrum wherein manufacturers may not have designed their products for a retail audience, but these funds nonetheless get marketed to prospective retail clients who may lack the necessary knowledge. Are manufacturers and distributors sufficiently aligned on this issue? Suitability assessment is another theme where inconsistencies appear between regulations and between jurisdictions, forcing firms to put in place ever more complicated processes.
- **PRIIPs and MiFID II are trying to find one-size-fits-all rules for all investment products and client types, which is difficult given the inherent diverse nature of the field.** Investment products and strategies vary greatly between traditionally retail-oriented UCITS and AIFs in terms of transaction volumes, leverage, underlying assets, public versus private markets, usage of derivatives, and risk levels. The calculation and presentation of costs and charges has historically been loose and inconsistent across products and regulatory vehicles. In such a context, MiFID and PRIIPs are prescribing specific methods that are often complex to interpret according to each type of product. This can generate misaligned reporting and disclosures between funds of even similar categories, which runs contrary to the spirit of the rules.

- **The debate between *ex ante* and *ex post* performance presentation continues.** PRIIPs takes a particular view on performance presentation in the KID, focusing on *ex ante* performance scenarios, which are oftentimes complex to calculate and potentially difficult to interpret, again creating the potential for misrepresenting a strategy.
- **Outsourcing in the asset management industry has often resulted in proprietary data becoming potentially difficult to obtain by the investment firm at the granular level now required by PRIIPs and MiFID.** Firms have often had to create specific processes involving their third-party service providers (e.g., administrators, custodians) to obtain the necessary data. Are the right data available? Are they of sufficient quality? As asset managers remain responsible for the reports they produce, are they capable of producing the required data?

Through its membership and understanding of industry practices, CFA Institute is in an enviable position to clarify how practitioners are experiencing and effecting the operational changes prompted by regulatory developments in their day-to-day processes.

6. List of the survey questions

Presentation of the survey:

Product governance is a key part of the investment management value chain. CFA Institute is interested in taking the pulse of how the relationship between manufacturers, distributors, advisors, and, ultimately, the end-investors has evolved over time. Is the industry in a position to demonstrate its services provide value for money to investors in a context where the economics of the field have been challenged by an increasing focus on costs, charges, and transparency, where regulatory pressure continues to have an impact on competition forces and where technology is aiming to radically change the dynamics of the relationship between these actors?

The following table presents all the questions that compose the survey:

Question number	Question titling	Rationale for question
<p>The following questions (1–9) relate to general inquiries about product governance practices in the investment management industry in the EU, the state of play on transparency, and the effects regulatory developments (Markets in Financial Instruments Directive II [MiFID II] and Packaged Retail and Insurance-based Investment Products [PRIIPs]) may have had on how products are manufactured and then sold to end-investors.</p>		
1	<i>Do you think the relationship between manufacturers and distributors/advisors of investment products in the EU has changed materially since the introduction of MiFID II and PRIIPs?</i>	Measure if practitioners believe more care is given to product design so that marketing can target the right client base with the right product, which is ultimately about providing effective investor protection.
2	<i>One of the objectives of the product governance rules under MiFID II is to improve the understanding distributors and advisors have of the investment products they market, thanks to more effective communication with the product manufacturers. Do you think this situation has improved?</i>	Measure if practitioners think the entities that market investment products have improved their understanding of the products' characteristics.
3	<i>MiFID II and PRIIPs have prompted a debate as to whether the administrative process required to assess an investor's suitability prior to making an investment has become too complicated and suffers from inconsistencies. How do you feel about this statement?</i>	Measure to what degree practitioners think the various rules dealing with investor information and suitability across the different regulatory frameworks have become too complicated and inconsistent.

4	<i>In general, do you think retail investors obtain enough or complete information related to the investment products they choose to invest in? Consider altogether costs, charges, risks, and performance information elements.</i>	Measure if practitioners think the information investors receive is enough, or of sufficient quality, or too complex, or inconsistent across providers and jurisdictions.
5	<i>In general in today's markets, do you think the marketing rules in the EU are sufficiently clear for the cross-distribution of investment products across the various jurisdictions?</i>	Measure if practitioners think EU directives are applied consistently and efficiently across Member States.
6	<i>Do you think ESMA should be granted more powers to oversee the cross-distribution of investment products across the EU?</i>	Measure if practitioners agree that further centralisation of marketing rules and enforcement would facilitate and encourage cross-border distribution of investment products.
7	<i>How do you feel about the effectiveness of the currently enforced PRIIPs Regulation for the Key Information Documents (KID) (Regulation (EU) No 1286/2014) and UCITS Regulation for the KIID (Commission Regulation (EU) No 583/2010), both of which prescribe the information that should be provided to prospective customers before they make an investment?</i>	Measure if practitioners think the investor information frameworks have helped investor protection or made the rules more complicated instead.
8	<i>Please select the statement(s) that most closely represent the areas you believe need improvement concerning the current mandatory disclosure documents (UCITS KIID and PRIIPs KID).</i>	Obtain from practitioners their view as to what should be improved in the investor information document, including performance presentation and costs.
9	<i>Are you making use of outsource service providers to produce the Key Information Documents?</i>	Measure the extent to which firms have relied on outsourcing to comply with the investor information requirements and the associated costs or administrative burden.

The following questions (10–12) relate specifically to the Joint Consultation Paper concerning amendments to the PRIIPs KID released by the European Supervisory Authorities (ESAs) on 16 October 2019, related to the Draft amendments to Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 on KID for PRIIPs.

10	<i>As it stands, UCITS investment products will have to produce a PRIIPs KID starting on 1 January 2022. Please indicate the extent to which you agree or disagree.</i>	Measure if practitioners think that for simplicity, investor information rules and documents should be unified regardless of the product type.
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11	<i>In order to align the prescriptions of the UCITS Regulation and the PRIIPs Regulation on a unified KID format, the ESAs are considering including past performance (currently not prescribed under PRIIPs). How do you feel about this possibility?</i>	Measure if practitioners think past performance should be included as part of investor information in addition to or as a replacement for performance scenarios.
12	<i>Another comment on the PRIIPs KID was on the treatment of indirect transaction costs, and more specifically the slippage calculation method. Should these be considered part of investor information documents and how?</i>	Measure the extent to which the industry is clear on how slippage (indirect market impact) may represent a cost to investors that should be reported as such.

7. Detailed results of the survey

In this section, we review and explain each question of the survey, using the following logic:

- What is the issue? Here we also provide background details.
- What is the question asked? Included is a graphic of the responses.
- What is the result of the survey? Interpretation concludes this part.

7.1 The relationship between manufacturers and distributors

What is the issue?

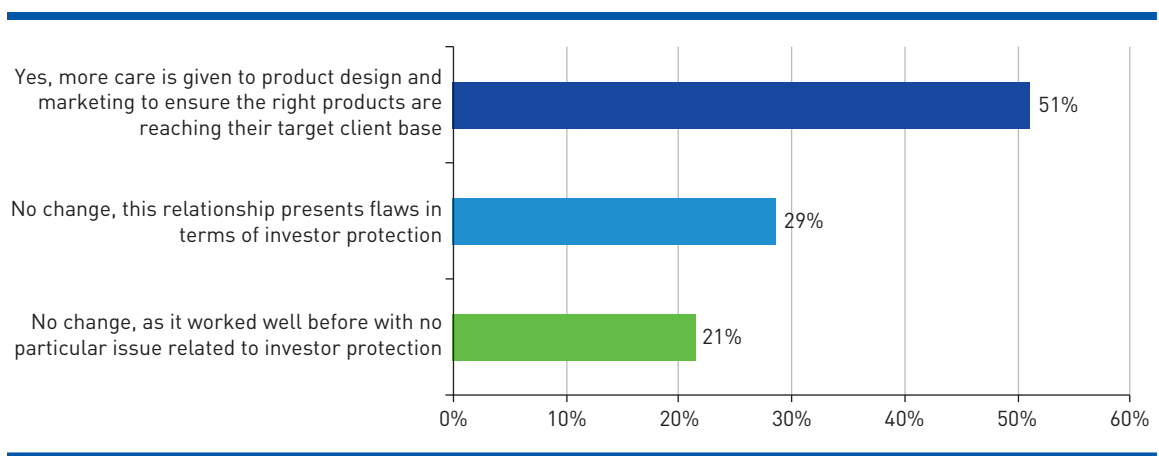
MiFID II has enacted a conceptual recalibration of the chain of responsibility between the manufacturer and the distributor of investment products. Suddenly the rules forced both actors to cooperate in ensuring that the right products were being sold to the right prospective clients. The notion of joint responsibility forced manufacturers to engage more directly with distributors and advisors. Manufacturers have had to think more structurally about the target markets of each product and work with the distributor on a two-way process aimed at verifying the adequacy of the selling and marketing process against this target market. Manufacturers can no longer claim they are not responsible for mis-selling.

What is the question asked?

Q1. Do you think the relationship between manufacturers and distributors/advisors of investment products in the EU has changed materially since the introduction of MiFID II and PRIIPs?

What is the result of the survey?

It is always difficult to establish a direct causality relation between regulation and its eventual effects on industry practice. Yet, most practitioners seem to agree that product design is given more care, which could indicate that investment products are constructed with more direct consideration for the interests and needs of the end client target market. In isolation, this result alone would be welcome by conduct regulators, who are naturally working towards a better alignment of the interests of providers and clients.



Ultimately, this question is about value for money, which has been a major issue for the investment management industry since the 2007–08 crisis. It should be recognised that quantitative easing has resulted in the double whammy of eroding the capacity of active managers to add alpha, which in turn has prompted a reconsideration of whether these managers add value in the context of lower interest rates and the rise of low-cost and often passive products. The result is a cycle of diminishing marginal returns. Focusing on product design and client service could be a way for managers to regain the trust of investors.

7.2 Do distributors and advisors understand the products they are selling well enough?

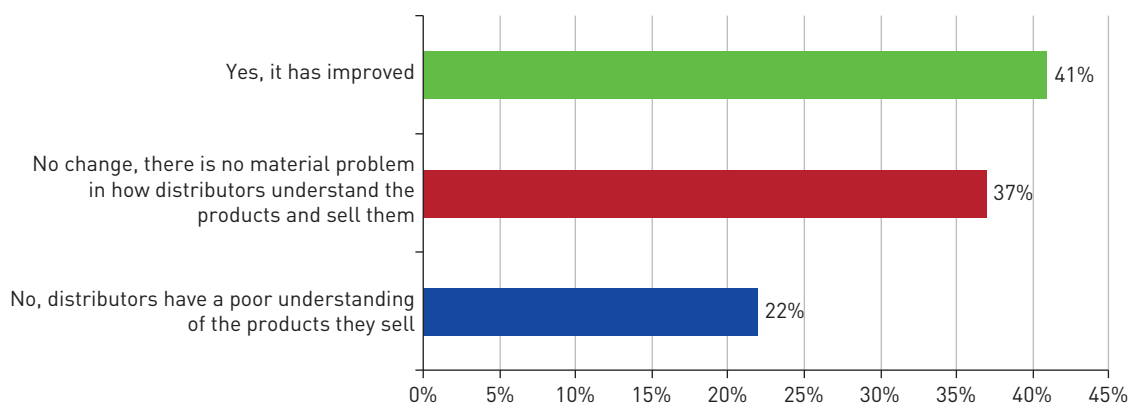
What is the issue?

MiFID II and PRIIPs are essentially forcing manufacturers to explain the characteristics of their products in a sufficiently standardised manner so that distributors receive and integrate the information they need when marketing to the end investors. The issue had been that distributors or advisors may not have mastered those technical details well enough—or perhaps no real process was in place for this to happen?—so that the tail-end advice may have lacked in quality, relevance, suitability, or appropriateness.

What is the question asked?

Q2. One of the objectives of the product governance rules under MiFID II is to improve the understanding distributors and advisors have of the investment products they market, thanks to more effective communication with the product manufacturers. Do you think this situation has improved?

What is the result of the survey?



The results here could indicate a marked perceived improvement in how distributors and advisors are making use of the information they receive from the manufacturers to construct their marketing pitch. In other words, has regulation helped reconcile the level of information manufacturers think they have provided the distribution side with the level these entities expect to receive or need to properly advise or market the products?

A sizeable portion of respondents still disagree, though, and believe this situation remains problematic. Such trends would be interesting to measure over time as regulators keep grappling with the fundamental problem of how much information is actually necessary, when abundance results in overkill, or how to reconcile quality and quantity.

7.3 The maze of suitability assessment

What is the issue?

MiFID II, PRIIPs, and UCITS each have in various degrees specific rules that pertain to how investor information, suitability, and appropriateness must be assessed prior to an investment product being marketed and eventually sold to prospective clients. Because these regulatory frameworks are meant to gradually converge—same thing with AIFMD—they also overlap with each other. Oftentimes, this overlap is imperfect and presents divergence in one or several respects, which adds complication and unnecessary administrative burden in the marketing and client onboarding process, thereby risking to undermine the primary goal of clarifying and securing the provider-versus-client environment.

As it stands, depending on the circumstances, firms have to consider the following frameworks when dealing with prospective investors:

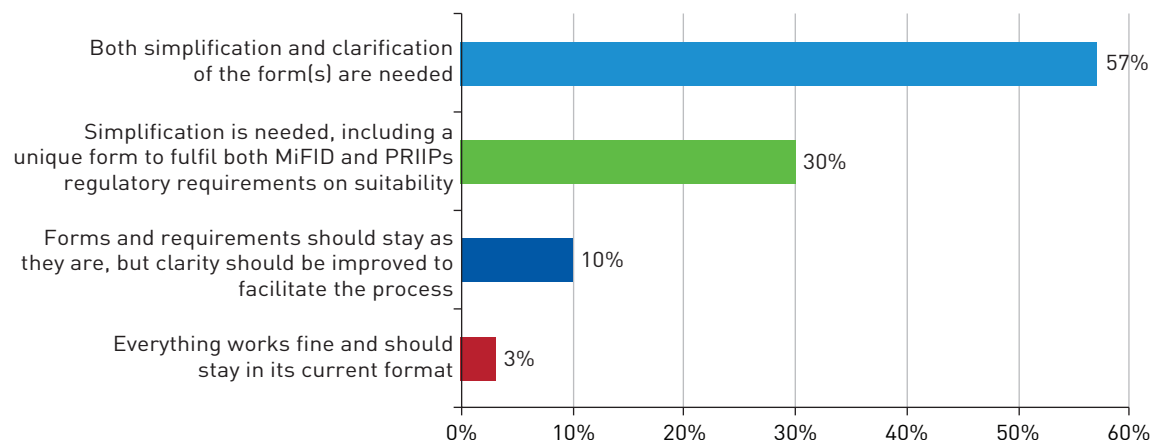
- MiFID II suitability assessment
- MiFID II EMT framework (for the definition of the target market)
- PRIIPs KID
- UCITS KIID

As discussed, these frameworks are not perfectly aligned (notably on how to assess clients' financial expertise), and this situation is made even more complex by each jurisdiction defining its own local rules when applying specific directives. The concept of effective retail and professional clients may vary between jurisdictions depending on local exemptions, opt-ins or opt-outs, and interpretation differences.

What is the question asked?

Q3. MiFID II and PRIIPs have prompted a debate as to whether the administrative process required to assess an investor's suitability prior to making an investment has become too complicated and suffers from inconsistencies. How do you feel about this statement?

What is the result of the survey?



Close to 90% of respondents were of the view that, one way or another, simplification and/or clarification is required. This information should be of value to policymakers and regulators. As for any law or rule, the intent needs to be clear and accepted, applicability needs to be agreed upon, and the benefits to society at large need to be understood.

As it stands, the risk is that the aforementioned processes are dealt with in a mechanical and automated manner, with high administrative costs, yet the underlying intent may not be fulfilled as expected. In other words, as a result of their complication and inconsistency, these frameworks risk being perceived as unbeneficial in terms of investor protection.

It is worth noting that 30% of respondents felt that unification of processes would be beneficial. Further convergence of definitions and operational guidance between the frameworks, including resolving the issue of regulation versus directive applicability, could be warranted.

On this question, the results from Bafin's second survey on MiFID II, conducted in January 2019, were quite interesting and revealing of the issues. Germany's Federal Financial Supervisory Authority focused its surveys on business conduct obligations and had a specific section on suitability reports. One of the conclusions from the second survey was that, precisely, the suitability reports that had been analysed largely failed to meet the legislation's objectives on this aspect of investor protection. The regulator was pointing to the very "formulaic" approach used by firms to demonstrate suitability and the need to harmonise practices across member states.⁴

7.4 How much investor information is enough, or when is it too much?

What is the issue?

How much is the right amount of investor information to be provided to prospective clients has always been a difficult question. Regulators have been working to windward on this issue through successive iterations.

⁴ See Bafin, *MiFID II in Practice*, 7 June 2019, https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2019/fa_bj_1905_MiFID_II_in_der_Praxis_en.html.

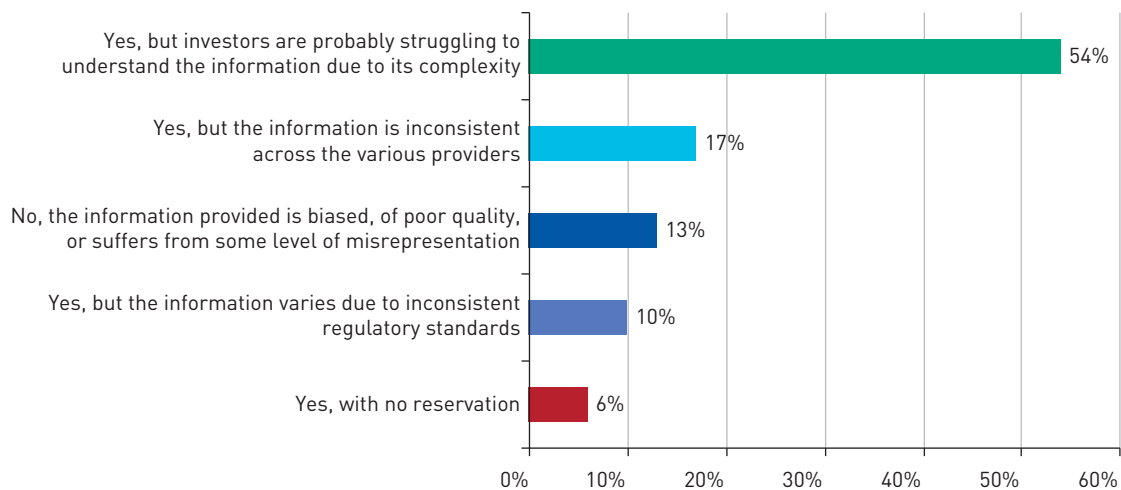
Another issue is how consistently firms apply rules and regulatory guidance. In an investment world dominated by diversity of products, investment styles, and underlying financial instruments, firms have naturally had to face interpretational issues.

Finally, it is difficult to judge a priori if prospective clients carefully read and understand the information they obtain, in a context where abundance and complexity of concepts—the presentation of performance, risk, and costs is a contentious issue—may have reached overkill.

What is the question asked?

Q4. In general, do you think retail investors obtain enough or complete information related to the investment products they choose to invest in? Consider altogether costs, charges, risks, and performance information elements.

What is the result of the survey?



A significant majority of respondents appear to believe investors already obtain enough information, yet it also seems clear that this view is somehow cynical because they also doubt this information is well understood or sufficiently useful to inform their decision making. Again, the issue becomes one of complexity and meaningfulness.

In our response to the ESA consultation on PRIIPs, we were advocating in favour of more consumer testing to ascertain with better practical knowledge how much information is necessary and the degree of complexity that could be deemed appropriate.

7.5 Are EU marketing rules sufficiently clear to facilitate the cross-border distribution of investment products?

What is the issue?

In principle, the passporting features provided under MiFID, UCITS, and AIFMD were a major selling point of these EU-wide regulatory frameworks to be accepted by the markets. The bargaining agreement was that in exchange for stricter conduct rules on investor protection, market participation, reporting, and transparency, firms would obtain a facilitated and simpler manner to export their products and services across the Union (i.e., market access).

Under the EU's Freedom of Establishment and Freedom to Provide Services provisions, the passports operate such that firms need only register their operating companies or investment vehicles once in any Member State to be granted the right to provide investment services and market their products across the EU.

The practical reality has proven to be a bit more complicated and cumbersome. On the one hand, the passporting process is not automatic and requires a certain degree of manual intervention between jurisdictional NCAs, involving specific paper processing, oftentimes intermediated by law firms or consultants, which adds to the costs and administrative burden. On the other hand, recall that EU directives are not always applied or transposed locally in perfect harmony. Differences in interpretation allow for flexible definitions concerning notions of client categorisation (i.e., retail versus professional clients and all the in-betweens), what constitutes marketing and what does not, or the suitability checks. Compounded at the level of the EU, firms often have to maintain complex matrices of marketing rules to ensure they stay on the right side of the law in each jurisdiction.⁵

⁵ See Ashurst, *ESMA AIFMD advice and opinion on NPPR and passporting regimes*, 1 July 2015, <https://www.ashurst.com/en/news-and-insights/legal-updates/esma-aifmd-advice-and-opinion-on-nppr-and-passporting-regimes/>

A particularly thorny issue has historically been that of premarketing or market sounding. In the world of not-so-traditional investments (e.g., AIFs and other alternatives), premarketing usually permits testing the market before spending on actually launching and structuring an investment vehicle. This framework used to sit at the boundary of regulated activities and therefore in the no-man's land of marketing to professional and quasi-professional (perhaps sophisticated retail?) prospects. Yet EU jurisdictions had very different interpretations of AIFMD marketing rules, some banning premarketing, some controlling its remit, and others disregarding its existence and therefore providing no definition. Cross-border marketing in such a context was a complicated endeavour. In June 2019, Directive (EU) 2019/1160 was adopted, amending AIFMD and crystallising a harmonised definition of premarketing. Critics of the new framework claim the definition is very narrow and severely restricts the capacity firms have to discuss investment strategies with prospects before a vehicle is launched.⁶

Reverse solicitation is another aspect that remains nebulous (see Note 4). Despite regulatory attempts to clarify what/how/when an investment was made without any form of direct marketing, it remains grey territory, especially in transnational and non-EU activities.

Clearly, an enhanced framework on cross-border marketing seems feasible given that the passport facility remains a major advantage the EU provides between different jurisdictions, for it has no equivalent in the rest of the world. In fact, the UCITS format, for example, has also proved popular outside the EU and notably in Asia, gradually emerging as a more and more global standard.⁷ Of course, regulators will need to pay attention to regulatory arbitrage and the consistency of application of the rules across Member States in addition to ensuring that UCITS rules, for example, are not stretched to a point where their spirit could become compromised. We have seen how investment eligibility and flexibility rules in UCITS may have played a role in recent liquidity issues observed in 2019–2020, as firms have been grappling with falling interest rates and generally converging rates of return across assets. This prompted in some cases a search for yield in strategies which may have stretched the liquidity status of certain vehicles. Regulators have been reacting to this situation by tightening liquidity rules on specific types of retail schemes⁸ and even the Bank of England indicated that liquidity of investment funds that invest in inherently illiquid assets could pose systemic risk in

⁶ See Sidley, *EU AIFMD: New Rules on Pre-Marketing and Reverse Solicitation*, 21 May 2019, <https://www.sidley.com/en/insights/newsupdates/2019/05/eu-aifmd-new-rules-on-pre-marketing-and-reverse-solicitation>

⁷ See Romil Patel, *Ucits' Asia dominance continues*, Funds Global Asia, 30 July 2019, <http://fundsglobalasia.com/news/ucits-asia-dominance-continues>

⁸ See FCA, *FCA confirms new rules for certain open-ended funds investing in inherently illiquid assets*, 30 September 2019, <https://www.fca.org.uk/news/press-releases/fca-confirms-new-rules-certain-open-ended-funds-investing-inherently-illiquid-assets>

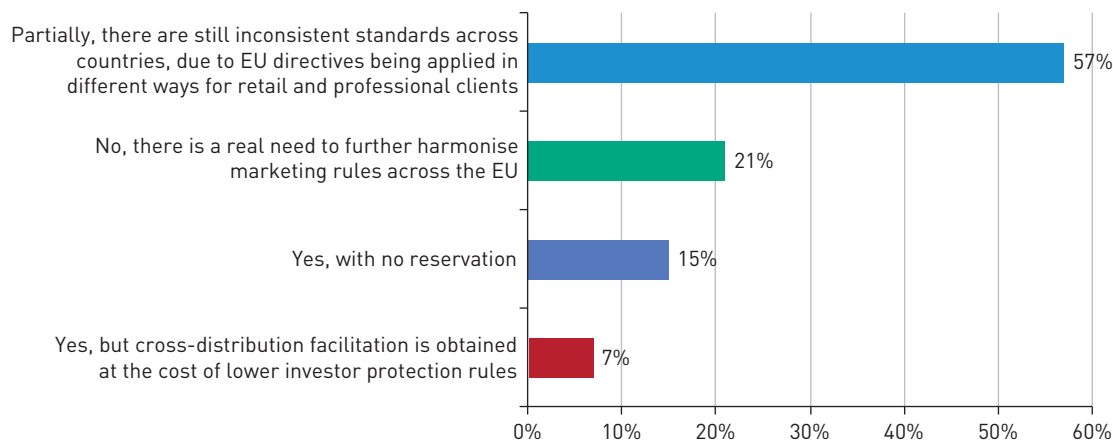
strained market conditions.⁹ The issue at stake here is that of balancing the liquidity of assets and liabilities in investment funds to mitigate potential systemic risk. Obviously, such rules would be most efficient if applied consistently across Europe.

For regulators and policymakers, the balance is to be found in facilitating cross-border distribution of financial products, which is a key objective of the CMU,¹⁰ but not at the cost of lower investor protections that could be caused by inconsistent transposition of the directives across Member States.

What is the question asked?

Q5. In general in today's markets, do you think the marketing rules in the EU are sufficiently clear for the cross-border distribution of investment products across the various jurisdictions?

What is the result of the survey?



The response obtained in the survey seems to indicate that a clear majority see genuine merit and operational as well as commercial interest in the passporting features, yet the

⁹ See *Financial Conduct Authority and Bank of England statement on joint review of open-ended funds*, 16 December 2019, <https://www.bankofengland.co.uk/news/2019/december/open-ended-funds>

¹⁰ See European Commission, *Overview of the capital markets union*, https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/what-capital-markets-union_en

response also confirms that inconsistent application of the rules across Member States is detrimental to a valid intent.

7.6 Should the European Supervisory Authorities be granted more centralised powers to directly oversee cross-border marketing in the EU?

What is the issue?

One of the arguments in favour of more centralised oversight and supervision of cross-border marketing rules and conduct is precisely to reduce inconsistent localised application of EU directives.¹¹

In today's context dominated by frictions between those in favour of more European integration—dare we use the term *federalisation*?—and those preferring local freedom and flexibility precisely on the grounds that one-size-fits-all rules are inadequate in less-developed markets,¹² for example, such a move to provide ESMA with more oversight and supervisory powers on cross-border marketing could seem bold—yet is it necessary?

What is the question asked?

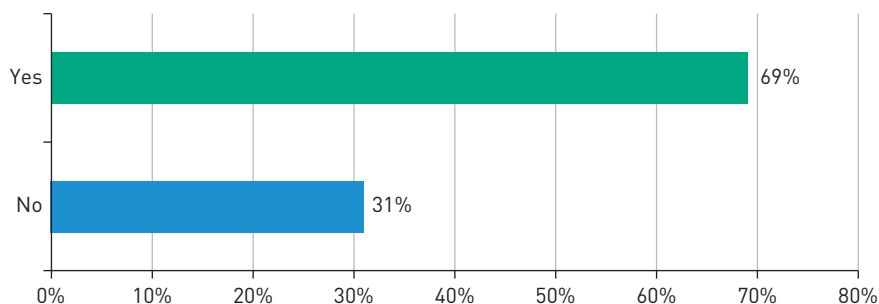
Q6. Do you think ESMA should be granted more powers to oversee the cross-distribution of investment products across the EU?

What is the result of the survey?

Respondents appear to be largely in favour of ESMA centralising more supervisory powers over cross-border marketing. One could infer that firms are logically interested in and focused on operational simplification. This is natural, as we are in parallel observing a rise of fixed administrative costs and therefore of barriers to entry that are affecting the historical economics of the field (on this issue and the broader theme of a changing asset

¹¹ See LexGo.lu, *EU legislative proposals to facilitate the cross-border distribution of investment funds*, 21 March 2018, <https://www.lexgo.lu/en/papers/commercial-company-law/financial-law/eu-legislative-proposals-to-facilitate-the-cross-border-distribution-of-investment-funds,118414.html>

¹² See Catherine McBride, *Anti-competitive regulations and the harm they cause*, Institute of Economic Affairs (IEA), <https://iea.org.uk/anti-competitive-regulations-and-the-harm-they-cause-part-1/>



management value chain, see BCG's latest report on global asset management¹³). A better functioning passport and cross-border framework would go a long way in reconciling the investment industry with a demanding and expanding regulatory umbrella.

7.7 How effective are Key Information Documents in enhancing investor protection?

What is the issue?

MiFID II and PRIIPs elevated investor protection as the linchpins of regulatory intervention. The central idea is to create and foster a virtuous circle of trust: If investors feel confident the markets work in their interest, they will invest their private savings in productive and longer-term financial products, which will in turn fund the economy and provide solutions for retirement planning. Financial intermediaries are the necessary cogs in this system to make it work efficiently. Essentially, the role of finance and capital markets is to cost-effectively channel capital from where it is owned to where it is needed, with regulation the useful friction in the machinery to ensure industry practices are not biased against the interest of investors.

At the root of this circle of trust is the notion that investors should obtain quality information from the industry and be literate enough in financial theory to make informed decisions. This study is concerned with the former concept, whereas the latter, financial

¹³ See Renaud Fages et al., *Global Asset Management 2019: Will these '20s roar?*, BCG, 31 July 2019, <https://www.bcg.com/publications/2019/global-asset-management-will-these-20s-roar.aspx>

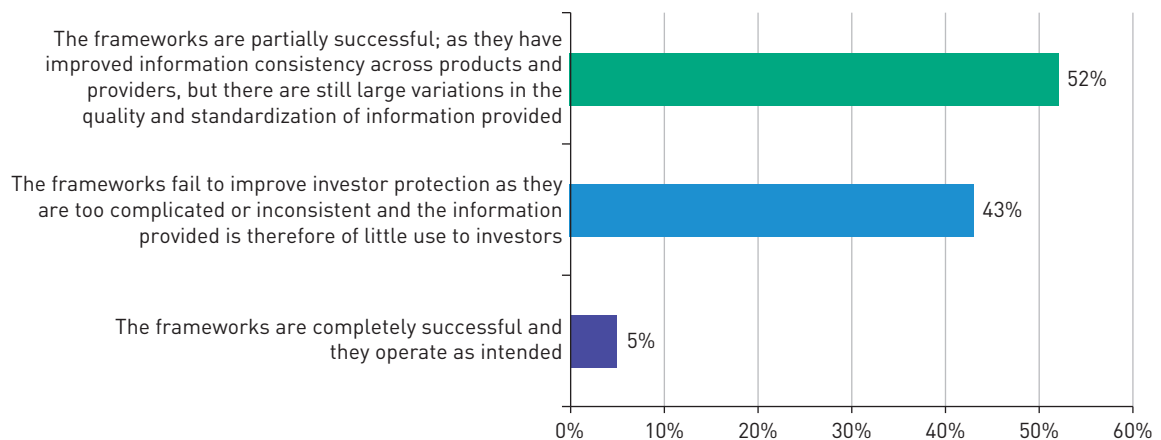
literacy, is a holy grail regulators have been pursuing for years, or what actions should the government and the regulators engage in to help the general population make appropriate decisions for their financial security.

The question then becomes how much information is needed, in what granularity, how complex should it be, and to what extent should it be standardised. PRIIPs was initiated for that purpose.

What is the question asked?

Q7. How effective is the currently enforced PRIIPs Key Information Document (KID) regulation (Regulation (EU) No 1286/2014) and UCITS Regulation for the KIID (Commission Regulation (EU) No 583/2010), both of which prescribe the information that should be provided to prospective customers before they make an investment?

What is the result of the survey?



In majority, respondents appear to vindicate the concept that investor information should be standardised to a certain degree. This majority believes information consistency has improved with PRIIPs and the KID. Yet, they recognise the level of standardisation and, most important, the quality of the information provided remain uneven across providers. Of these respondents, 43% are implying that such shortcomings are important enough that the regulation at large fails to improve investor protection because the information

provided is too complicated to be useful to investors. Clearly, this problem needs to be addressed by regulators if they wish to convert a good try into a successful resolution.

It is worth noting that this is what the ESAs have set out to do with the consultation launched in October 2019 on PRIIPs (see Note 2).

7.8 Which areas of the Key Information Document should be improved?

What is the issue?

Since the introduction of the PRIIPs KID in January 2018 (date enforced), commentators have had time to think about possible improvements to the form.

Contentious areas necessarily have to do with how risks, costs, and performance are calculated and then presented. For CFA Institute, for example, the absence of past performance information is a shortcoming. Complicated calculations for *ex ante* performance scenarios have been a serious issue as investment practitioners themselves struggle to reconcile the results with their own internal assessments of potential returns.

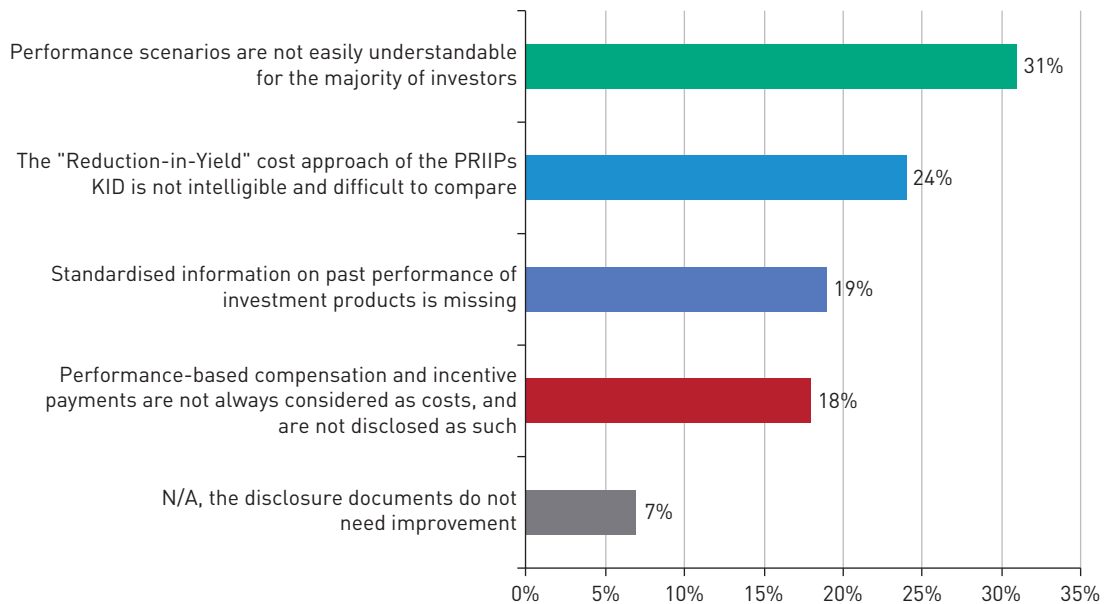
At large, the issue is one of representation, comparability, and interpretation. The more complicated the calculations, the less meaningful the results risk becoming or the more difficult it could be to compare providers who are interpreting guidance differently across products.

What is the question asked?

Q8. Please select the statement(s) that most closely represent the areas you believe need improvement concerning the current mandatory disclosure documents (UCITS KIID and PRIIPs KID). Select "N/A" if you feel the disclosure documents do not need improvement.

What is the result of the survey?

Unsurprisingly, respondents mentioned performance scenarios as the first area requiring improvement, as not easy to interpret for investors. Essentially, the moderate, favourable and unfavourable scenarios in the PRIIPs KID are constructed as variations of the normal distribution of past performance to infer future performance by creating natural asymptote of returns so that the three scenarios do not diverge too much from each other. The



stress scenario is the most contentious because it is meant to be a catastrophic shock on the fund's assets to express that investors may suffer extreme losses in extreme situations. Results are therefore not easy to understand either for investors or for practitioners, given the prescriptive nature of the calculation method.

The particular presentation of costs based on the concept of reduction in yield (RIY) over time came second. In this case, the underlying idea is that of the cost drag over time, as Vanguard's founder John C. Bogle describes with his *Costs Matter Hypothesis*.¹⁴ In a *Financial Analysts Journal*[®] article published in 2014,¹⁵ he expanded on William F. Sharpe's essay "The Arithmetic of Investment Expenses" (2013)¹⁶ by explaining that all-in investment expenses that took account of all costs (i.e., including transaction costs, sales commissions and the cash portion), not only management fees, caused a significant performance drag over the long term, focusing the purpose of his study on the build-up of a retirement pot for savers; hence the still relevant nature of his theory today. The RIY legitimately aims to democratise

¹⁴ See Ben Carlson, *John Bogle on All-In Investment Expenses*, A Wealth of Common Sense (blog), 26 December 2013, <https://awealthofcommonsense.com/2013/12/john-bogle-investment-expenses/>

¹⁵ See John C. Bogle, "The Arithmetic of 'All-In' Investment Expenses," *Financial Analysts Journal* 70, no. 1 (2014), <https://www.tandfonline.com/doi/abs/10.2469/faj.v70.n1.1>

¹⁶ See William F. Sharpe, "The Arithmetic of Investment Expenses," *Financial Analysts Journal* 69, no. 2 (2 November 2013), <https://www.tandfonline.com/doi/abs/10.2469/faj.v69.n2.2>

this calculation so that prospective investors can measure the effect of costs over the long term and compare various investment solutions. This approach is difficult to implement in practice, however, mostly because a multitude of variables are involved in different ways between funds, creating a complex dynamic, notably between explicit and implicit costs.

In third place, respondents indicated they believed past performance should feature in the KID, just as it does in the UCITS KIID. CFA Institute supports this view.

7.9 How firms have resorted to outsourcing KID production

What is the issue?

Outsourcing in asset management has been causing concern to regulators. Back in 2013, the Financial Conduct Authority (FCA) in the UK released a comprehensive study of the potential conduct and systemic risks that could arise if investment firms did not properly manage their outsourcing arrangements as prescribed under MiFID and local UK rules.¹⁷ The overwhelming concern is one of resilience: Are investment firms' contingency plans prepared for the failure of a critical service provider to maintain operations and service to customers?

One particular aspect of outsourcing risk oversight regards data management. As discussed previously, the traditional asset management business model is being challenged and technology, including information processing, is becoming a major source of competitive advantage. IT developments—some call these an arms race—require significant resources. In such a context, outsourcing is perceived to be a way to gain in scale without incurring as much structural costs as would be the case under purely internal developments. The issue then becomes one of firms losing too much control over their data.

Under PRIIPs, investment firms remain fully responsible for the entirety of the KID produced, yet outsourcing is still permitted. A balance needs to be found between optimising processes using the expertise and operational scale of external providers, on the one hand, and retaining enough control over the production process and in the end the quality of the information communicated to end-investors, on the other.

What is the question asked?

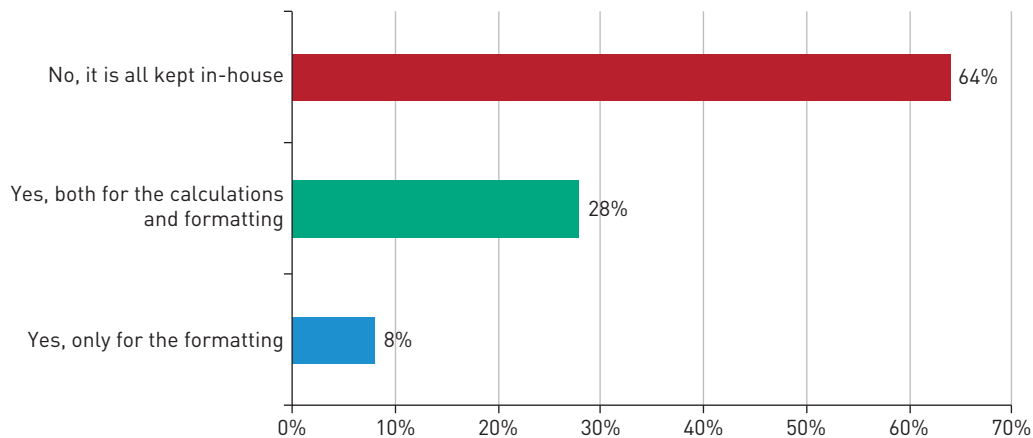
Q9. Are you making use of outsource service providers to produce the Key Information Documents?

¹⁷See FCA, *Outsourcing in the asset management industry*, 4 November 2013, <https://www.fca.org.uk/publications/thematic-reviews/tr13-10-outsourcing-asset-management-industry>

What is the result of the survey?

Perhaps surprisingly, a large number of respondents reported that the firms where they are employed keep all operations related to KID production (i.e., calculation and formatting) in-house.

One could speculate that the intrinsically complex nature of the prescribed calculations and the large amount of data points necessary to process continue to require a significant level of direct handling by investment firms. This situation could possibly change over time as fund administrators and custodians adapt their services to asset managers' needs while allowing for sufficient control over and understanding of the results so that investment firms can continue to safely claim compliance with the rules.



7.10 Should there be a unique Key Information Document for all types of products (UCITS and non-UCITS)?

What is the issue?

PRIIPs KID and UCITS KIID overlap in an unfortunate manner, such that UCITS may have to produce both a KID and a KIID in 2022. As it has stood, UCITS has benefited from an exemption to produce a PRIIPs KID.

In April 2019, the EU Parliament adopted the 2018 *New Legislative Proposals on Facilitating Cross-Border Distribution of Investment Funds*, part of the broader CMU action plan. The EU Parliament agreed to a new directive and regulation to this effect.¹⁸ This approval effectively extended the UCITS exemption to 31 December 2021. Yet this extension is only a temporary relief, given that no solution is forthcoming after that date.

The issue, therefore, is what to do with the KID and the KIID, which continue to differ in significant ways, such as in the presentation of past performance. The October 2019 consultation was partly about how to bridge the gaps between the two frameworks.

We wanted to ask members if they would favour an all-out simplification and unification of the investor information documents while legislators are debating what to do with this conundrum.

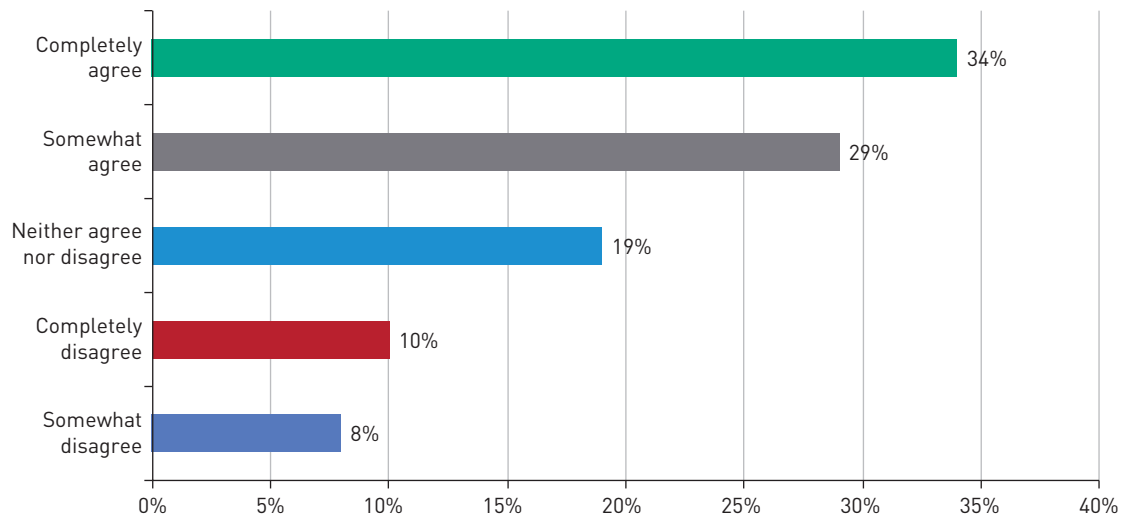
What is the question asked?

Q10. As it stands, UCITS investment products will have to produce a PRIIPs KID starting on 1 January 2022. Please indicate the extent to which you agree or disagree with the following statement: There should be a unified version of the PRIIPs KID for UCITS and non-UCITS products alike.

What is the result of the survey?

The survey results are not entirely conclusive, yet most respondents seem to favour simplification and unification to some extent. We could assume that hesitation to fully vindicate a unified form stems from the diversity of practitioners who operate in fields with varied sets of investment strategies and vehicle types. The one-size-fits-all approach is operationally appealing, yet perhaps some granularity—at least in calculation methods?—should be retained to ensure the specific characteristics of not-so-traditional products may be taken into account. The risk is again that the information produced loses in representation what it gains in simplification. In this regard, the calculation and presentation of costs spring to mind. Depending on how costs are presented, some strategies may be at a structural disadvantage or advantage (e.g., if they trade more or less often, if transaction or up-front costs are inherently more important, if incentive fees are charged, if market impact in trading is significant).

¹⁸ See Maya Van Belleghem, *New EU directive and regulation facilitating cross-border distribution of investment funds*, PwC, 21 July 2019, <https://news.pwc.be/new-eu-directive-and-regulation-facilitating-cross-border-distribution-of-investment-funds/>



7.11 Should Key Information Documents feature past performance?

What is the issue?

The UCITS KIID and the PRIIPs KID differ in one key aspect: The former features past performance, whereas the latter framework has preferred to focus on *ex ante* performance scenarios.

Here is what CFA Institute has answered to the question related to performance presentation in the ESAs consultation on PRIIPs KID:

CFA Institute strongly advocates for the reintroduction of past performance in the Key Information Document since that is the only actual information that is provided. However, it is necessary to separate this information, which is a fact and refers to historical data, from future performance scenarios, which are based on estimates. Both past performance and future performance should require different disclosures to support clear and fair communications with clients. We believe that investors would always like to see the track record of a financial product, as such data gives an initial feeling about an investment.

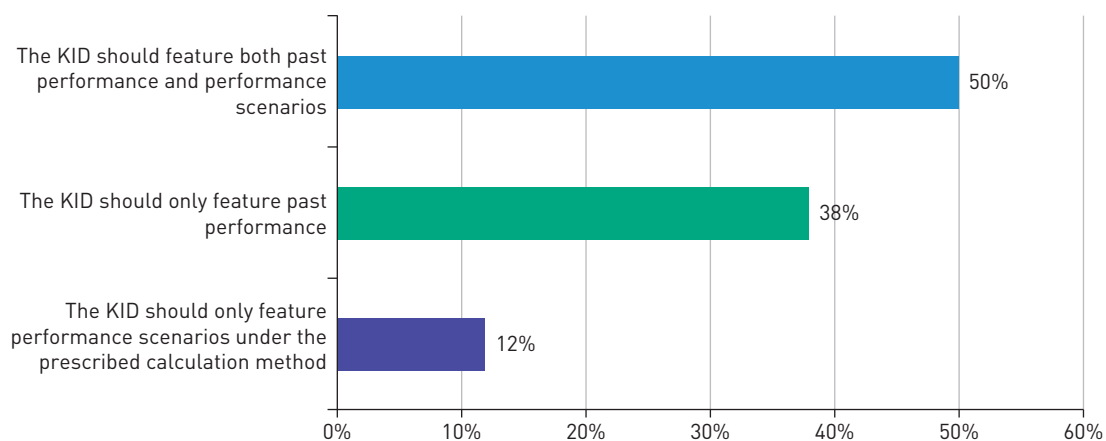
Concerning future performance scenarios, the KID should explain, in a clear manner, the underlying assumptions that have been used to make the estimates. These should be clearly understandable to the end investor. Moreover, investors should be made aware of all limitations of forward-looking estimates.

CFA Institute has developed the Global Investment Performance Standards (GIPS®) to provide an accepted set of best practices for the calculation and presentation of past investment performance. The standards, which are voluntary, facilitate the comparison of information between financial products provided by different investment firms and enhance investor interest and confidence as well as transparency by eliminating misrepresentations and past data omissions.

What is the question asked?

Q11. In order to align the prescriptions of the UCITS regulation and the PRIIPs regulation on a unified KID format, the ESAs are considering including past performance (currently not prescribed under PRIIPs). How do you feel about this possibility?

What is the result of the survey?



An overwhelming majority of respondents are vindicating the idea that past performance should feature in the KID one way or another. An interesting fact is that half the respondents would combine past performance (*ex post*) and performance scenarios (*ex ante*). This probably reflects that investment practitioners recognise the value in both types of measures. As most disclaimer messages claim, *past performance is no guarantee for future returns*. Therefore, combining *ex post* and *ex ante* measurement is perceived to be a valuable way for investors to judge how the managers of a given investment have performed in the past and how they would compare to other vehicles in a highly prescriptive modelling set of scenarios.

7.12 The controversial treatment of transaction costs and "slippage"

What is the issue?

One long, contentious issue in investment management has been how to properly account for transaction costs.

PRIIPs defines transaction costs as *the impact of the costs of buying and selling underlying investments for the product*.

Ways to calculate and report these costs abound in the financial literature. Yet, PRIIPs has set in regulatory stone a highly prescriptive method firms are kindly asked to follow for the calculation and presentation of these costs. The core issue is about implicit costs or the market impact of trading, aka slippage in its various forms. Not all funds are equal in how they theoretically or practically generate such costs. One could posit that an underlying objective is to expose or discourage excessive portfolio churning, which may have the side effect of essentially advantaging passive strategies.

Implementation shortfall has emerged over the years as the most advanced—or recognised as such—theoretical protocol to calculate and present transaction costs in investments. It has become the benchmark in transaction cost analysis (TCA), proving useful in effectively separating explicit and implicit costs. This method is taught and explained in the CFA® Program curriculum, for example. It breaks down the cost of trading into the following components:

- *Explicit costs*: Outright payment per transaction.
- *Market impact costs*: Any cost resulting from an order being executed at a price outside the current bid–ask.
- *Missed trade opportunity costs (MTOC)*: The gain (or loss avoided) if an order is not filled or only partially so. More common with limit orders, MTOC is measured as the difference between the closing price and the benchmark price weighted by the percentage of the order not filled.
- *Delay/Slippage costs*: Measure the trading costs caused by time delay in executing a transaction. Unlike opportunity costs, slippage is the result not of a trader holding out

for a certain price but of lack of liquidity (especially for large orders), which sees the price start to move away as the trade is filled.

- *Realised profit/loss*: Difference between the execution price and the closing price on the day before divided by the percentage of the order filled.

An interesting analysis of implementation shortfall was performed by financial data provider Markit.¹⁹ The Markit whitepaper discusses the limits of using slippage as the ultimate guide in measuring and improving trader performance, evaluating broker skill, understanding the effectiveness of different strategies, and even assessing the quality of different trading venues. Counterarguments to the central use of slippage in TCA include the negative slippage costs generated in adverse momentum trading environments and the situations with high demand for liquidity—both these characteristics tend to distort the meaningfulness of slippage in explaining the quality or weakness of portfolio trading implementation.

PRIIPs has made implicit costs and slippage central to how transaction costs should be reported, using the concept of execution price versus arrival price. The industry is debating whether the resulting figure constitutes market risk (i.e., the inherent uncertainty when participating in market activity) or a cost to investments clients should know about. It pitches different types of funds and strategies against each other as well. In equities, explicit costs are obvious, whereas some fixed income managers argue the bid–ask spread prevalent in bond markets does not necessarily constitute a cost of investing. The more granular the rules—and PRIIPs rules are such—the more specific the cases arising, like non-standardised OTC instruments with low liquidity and non-financial assets.

In this regard, in the second half of 2018 the FCA had initiated a review of how firms were applying the PRIIPs rules in the UK market. In a feedback statement released in February 2019,²⁰ a whole section had been dedicated to transaction cost disclosure and slippage in particular. Firms were invited to comment, and several of them reported that the slippage method sometimes led to a high degree of variability or fluctuations over time, that price availability could be a problem, and, as discussed, that negative costs can confuse readers.

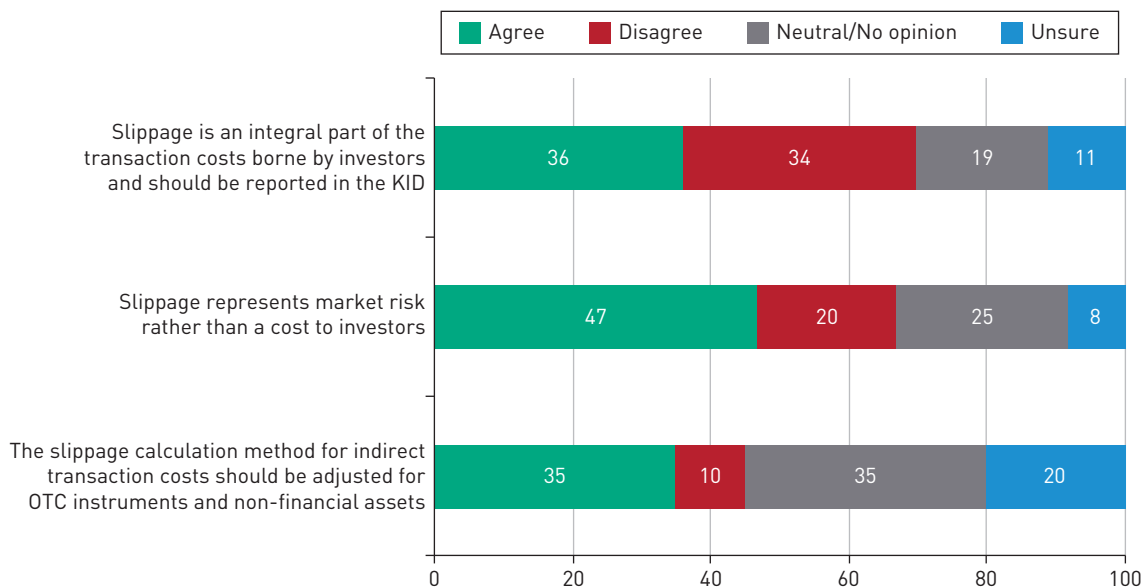
¹⁹ See Henry Yegerman and Alex Gillula, *The use and abuse of implementation shortfall*, Markit Whitepaper, February 2015, http://content.markitcdn.com/corporate/ResourceManager/uKXlIzZpqdxARc4kOA-C5A2/d/f/8psNhXQM75KACsv8TCCKTw2/Content/Documents/Products/WhitePapers/MKT_TCA_The_Use_and_Abuse_of_Implementation_Shortfall_whitepaper.pdf

²⁰ See FCA, *Call for input: PRIIPs regulation—initial experiences with the new requirements* (section on Costs, p. 13), 28 February 2019, <https://www.fca.org.uk/publications/feedback-statements/call-input-priips-regulation-initial-experiences-new-requirements>

What is the question asked?

Q12. Please select your level of agreement or disagreement with the following statements: Slippage represents market risk rather than a cost to investors; slippage is an integral part of the transaction costs borne by investors and should be reported in the KID; the slippage calculation method for indirect transaction costs should be adjusted for OTC instruments and non-financial assets.

What is the result of the survey?



To be fair, we were expecting the results to show that the industry is hesitating on how to consider implicit costs. Not all funds are the same, and not all managers consider market uncertainty in the same way. The results show this hesitancy. No clear majority emerges one way or the other. Close to 50% of respondents seem to favour the idea that slippage represents market risk rather than a cost to investors. Whereas close to 40% think slippage is a transaction cost that should be reported, 34% disagree. What is interesting is the high level of unsure and neutral responses, indicating the industry is not set on this question at large. More study and analysis therefore appear necessary to reach a more definitive conclusion on the nature and appropriate treatment of slippage as a transaction cost that should be reported to investors as such. This is information that should be of value to regulators and policy makers as they determine their work programme to enhance investors information regulations. CFA Institute would argue that consumer testing and practical case studies could be interesting avenues to consider in this regard.

8. Conclusion and key takeaways

In this work, we have explored how product governance has changed since the early 2010s in the EU asset management industry and the ways in which these changes have been induced by significant regulatory developments such as MiFID II and PRIIPs.

To inform our analysis, we have used the results of a survey conducted with our EU membership in December 2019.

Here are the key messages from this study:

- In general, the quality of the relationship between manufacturers and distributors of investment products in the EU appears to have improved since the introduction of MiFID II and PRIIPs, as perceived by surveyed practitioners. This reflects positively on the underlying objectives of regulators to improve investor protection.
- Consistency in applying directives across EU Member States and between investment firms on suitability assessment and investor information remains a problem. This may result in inefficient processes and is perceived to negatively affect investor protection.
- The industry appears to vindicate the intended purpose of investor information documents such as UCITS KIID and PRIIPs KID, its practitioners approving of the idea that prospective clients should be able to receive standardised information to enable comparability. Yet, this purpose may be harmed by a glut of information subject to interpretation and a high level of complexity, such that investors may lose sight of what is really important for their individual decision making.
- Passporting features of EU regulation provide a clear structural advantage for investment firms; yet, again cross-border marketing suffers from significantly complex matrices of regional versus local application of directives and marketing rules (e.g., on the definition of retail versus professional, marketing versus premarketing or suitability assessment). Clearly, here the industry seems to be requesting further harmonisation, clarification, and guidance.
- In relation to the preceding point on passports and cross-border marketing, the industry seems to favour further centralisation of oversight and regulatory monitoring of marketing practices with ESMA, as opposed to leaving the oversight to local regulators and localised rules.

- The industry appears to be particularly critical of the PRIIPs KID choice of showing performance through *ex ante* modelled scenarios only, which are suffering from a high degree of complexity. In this regard, a majority agree that past performance is missing and should also be presented. The presentation of costs is also suffering from excessive complexity, in particular the concept of Reduction-in-Yield, which remains difficult to comprehend, according to respondents.
- The industry is apparently not yet making large-scale use of outsourced service providers for the production of the KID, a majority of respondents claiming that both formatting and calculations are kept in-house. This could be a result of the complex nature of the rules, which requires deeper operational ties to administration agents to make outsourcing worthwhile from an efficiency and a cost perspective.
- The industry at large remains unclear on the treatment of implicit transaction costs in general and slippage in particular. Just under half of respondents think slippage is market risk (i.e., market uncertainty) rather than an actual cost to investors. Given the high level of unsure or neutral responses, it is fair to say further research and analysis should be initiated in this area to provide investors with more meaningful information.

9. Appendix 1: Survey demographics

The following charts and statistics describe the nature of the population sample that responded to the survey.

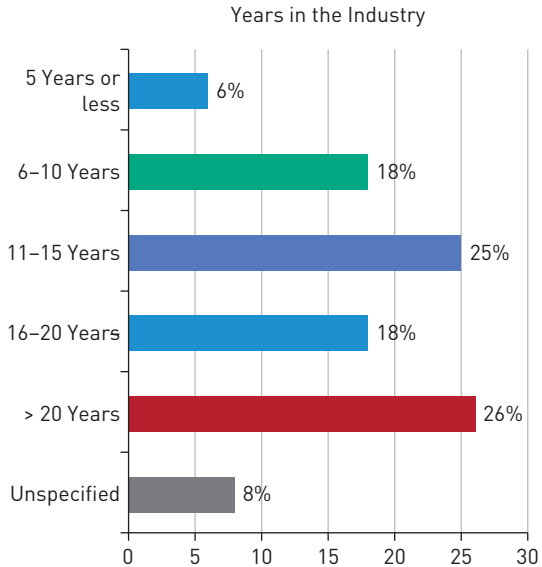
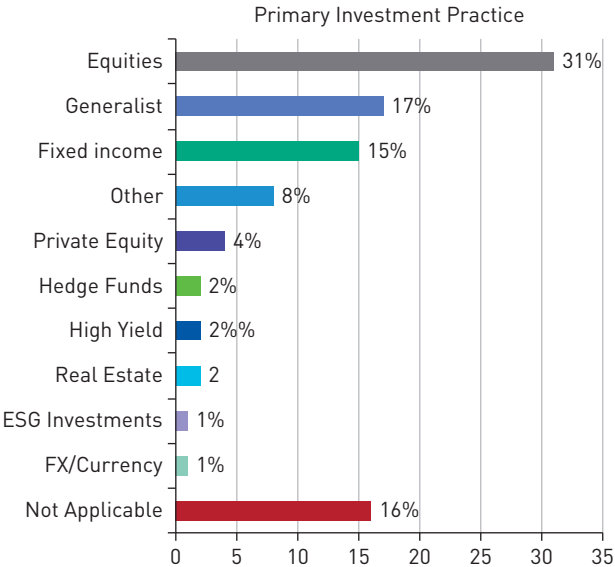
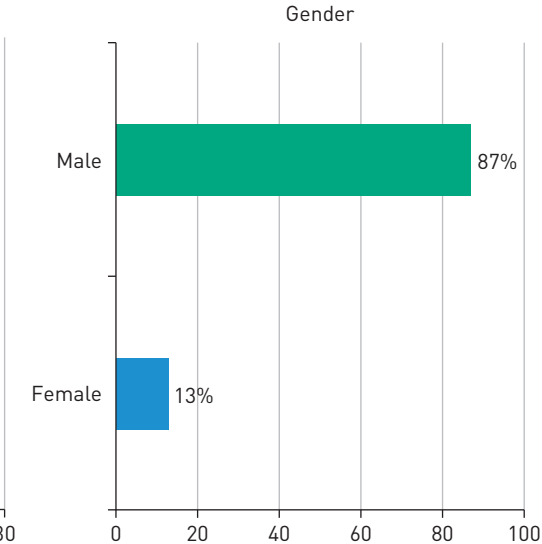
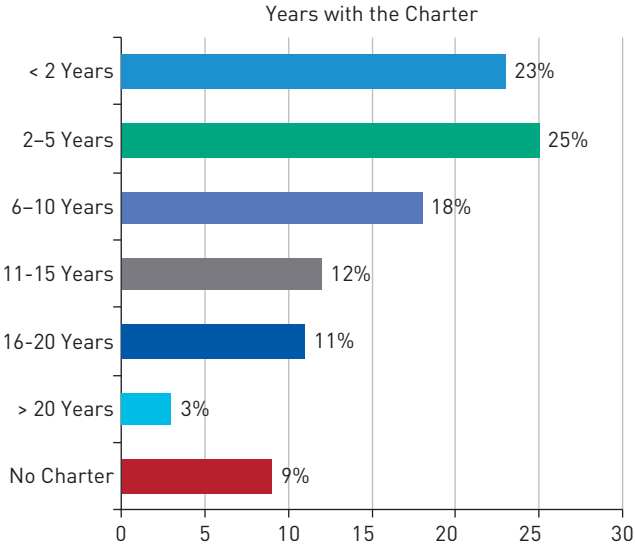
Total number of respondents: 527

Total response rate: 5%

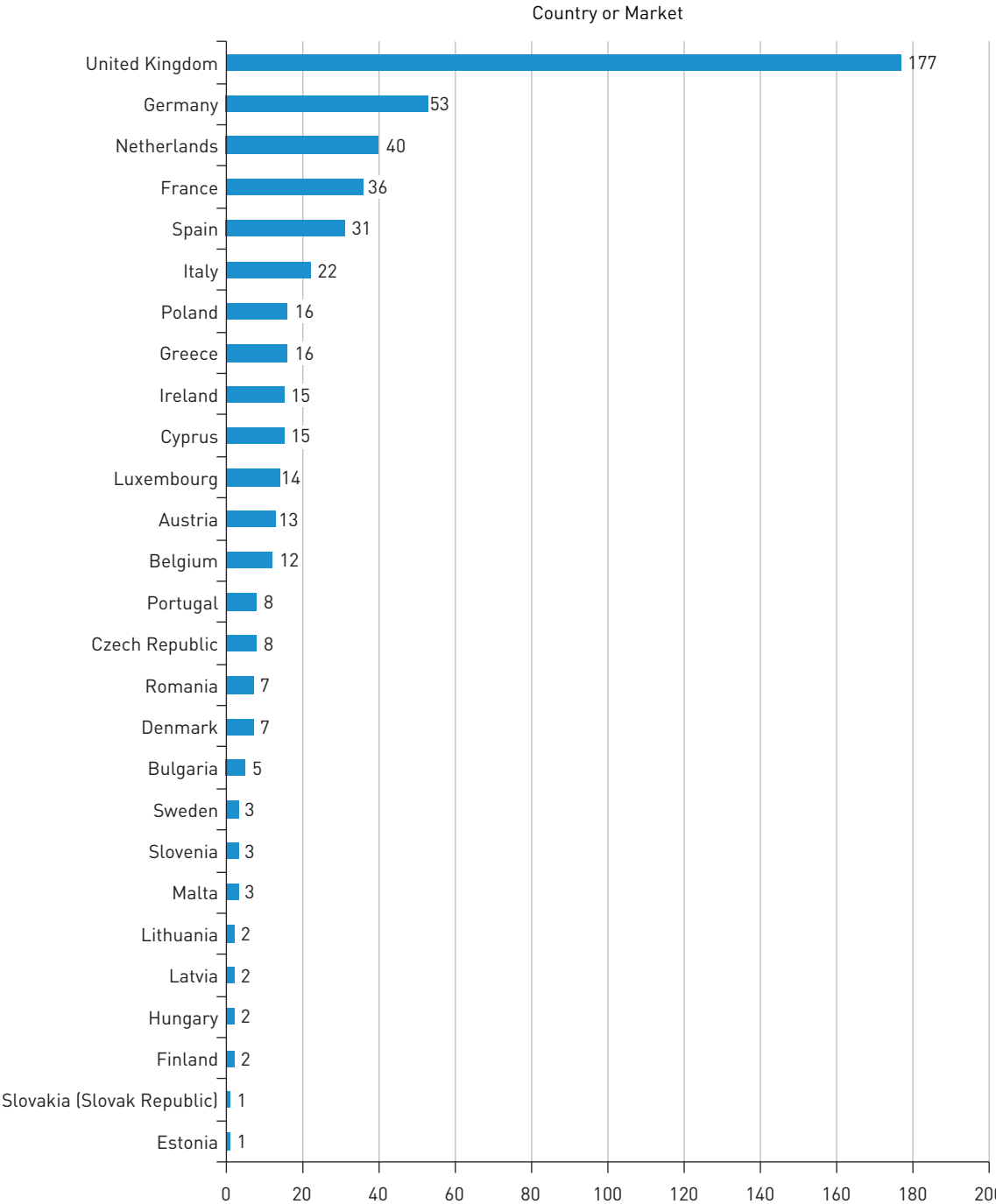
Survey completion rate: 94%

Margin of error: +/-4.18%

Survey Demographics







10. Appendix 2: Definitions and acronyms

AIFMD	Alternative Investment Fund Managers Directive Refers to Directive 2011/61/EU https://ec.europa.eu/info/law/alternative-investment-fund-managers-aifm-directive-2011-61-eu_en
CMU	Capital Markets Union Refers to European Commission action plan on building a capital markets union, 30 September 2015 https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union_en
EMT	European MiFID Template Refers to the FinDatEx MiFID technical working group on the draft EMT template https://www.findatex.eu/work-in-progress
ESA	European Supervisory Authorities Refers to the European system of financial supervision (ESFS) introduced in 2010: <ul style="list-style-type: none"> • European Systemic Risk Board (ESRB) And three European supervisory authorities (ESAs): <ul style="list-style-type: none"> • European Banking Authority (EBA) • European Securities and Markets Authority (ESMA) • European Insurance and Occupational Pensions Authority (EIOPA) https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/european-system-financial-supervision_en
ESMA	European Securities and Markets Authority https://www.esma.europa.eu/
FCA	Financial Conduct Authority (UK) https://www.fca.org.uk/
KID (PRIIPs)	Key Information Document
KIID (UCITS)	Key Investor Information Document

MiFID	<p>Markets in Financial Instruments Directive</p> <p>Refers to Directive 2004/39/EC (MiFID I) and Directive 2014/65/EU / Regulation (EU) No 600/2014 (MiFID II / MiFIR)</p> <p>https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/investment-services-and-regulated-markets-markets-financial-instruments-directive-mifid_en#markets-in-financial-instruments-directive-mifid</p>
NCA	National Competent Authorities
PRIIPs	<p>Packaged Retail and Insurance-Based Investment Products (Regulation)</p> <p>Refers to Regulation (EU) No 1286/2014</p> <p>https://ec.europa.eu/info/business-economy-euro/banking-and-finance/consumer-finance-and-payments/retail-financial-services/key-information-documents-packaged-retail-and-insurance-based-investment-products-priips_en</p>
RDR	<p>Retail Distribution Review (UK)</p> <p>https://webarchive.nationalarchives.gov.uk/20130402171718/http://www.fsa.gov.uk/about/what/rdr</p>
TCA	Transaction Cost Analysis
UCITS	<p>Undertakings for Collective Investment in Transferable Securities (investment vehicle or directive)</p> <p>Refers to the investment vehicle regulatory format of the same name or refers to Directive 2009/65/EC</p> <p>https://ec.europa.eu/info/law/undertakings-collective-investment-transferable-securities-ucits-directive-2009-65-ec_en</p>

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