JOHNSTON
CARMICHAEL

Johnston Carmichael LLP Chartered Accountants & Business Advisors Response to the FCA Call for Input: PRIIPs Regulation – initial experiences with the new requirements

September 2018

Head of Financial Services: Scott Holmes (Scott.Holmes@jcca.co.uk)

Policy Contact: Richard W Brown (Richard.Brown@jcca.co.uk)

Johnston Carmichael LLP
Chartered Accountants &
Business Advisors
7-11 Melville Street
Edinburgh
EH3 7PE

JOHNSTON CARMICHAEL

Introduction

Johnston Carmichael welcome the opportunity to respond to the FCA's call for input on initial experiences with the PRIIPs requirements. We are Scotland's largest independent audit and accountancy firm and a top 20 UK firm, with 56 partners and 650 staff. Our dedicated Financial Services team audit over £2.5bn of assets under management across more than 100 clients.

In the last calendar year, we have produced over 20 Key Information Documents (hereafter "KIDs") for clients ranging from unregulated collectives, to Real Estate Investment Trusts ("REITs"), Investment Trusts and Venture Capital Trusts ("VCTs").

This response is based on this body of experience.

We support the FCA's decision to address industry uncertainty and the practical challenges around certain aspects of the PRIIPs requirements.

We have provided responses to the questions raised in the following pages, but in summary, our experience is that the legislation in its current form does not disclose risk appropriately at a product level and generally fails to provide comparability amongst products. Therefore, we share the concerns raised by many others, that in isolation and in their current form, KIDs may be misleading for retail investors.

Q1: Are you experiencing problems with clarifying the scope of the PRIIPs regulation? Please provide examples of product types where you believe there is uncertainty as to whether they are in scope.

As a firm, we have found the scope to be clear. However, our experience is that there are manufacturers that manage Limited Partnerships who are unaware they may have to comply with the PRIIPs legislation.

It is our view, it would be helpful if the FCA could provide clarity as to the circumstances in which a KID is required out-with the Investment Trust / REIT / VCT universe.

Q2: Have you tried to resolve this uncertainty and faced difficulties in doing so? If so, please provide details and examples of the difficulties you have faced.

There are particular complications and uncertainty in relation to Limited Partnerships, as these are not traded on secondary markets. Some questions raised by our clients are:

- Is a KID required to be produced annually, even when no further investment is being sought? Many LP's operate in such a way that after launch and initial funding, no further funding is obtained, which may suggest that the production of an annual KID is meaningless;

- Many Limited Partnerships are aimed at both professional and institutional investors. There is lack of certainty in the industry around manufacturers' obligations to produce a KID where investors no longer meet professional status and are therefore classified as retail investors.

Q3: Have any of your calculations of transaction costs under the slippage methodology led to negative, zero or unexpectedly large transaction costs? If so, please provide examples, together with the full calculation of how the output has been obtained and explaining any assumptions that have been made.

Use of offer price compared with opening price

We have encountered several cases of the KID calculation returning a negative figure for transaction costs.

A key factor (pre-Christmas 2017) may have been that some manufacturers were not capturing both the order and execution price of transactions undertaken. Slippage was therefore calculated based on the opening and execution prices. Clearly the use of opening price gives imperfect results and will have contributed to negative transaction costs being observed.

We are aware that an alternative approach has been taken by some manufacturers, which is not consistent with the legislation post 1 January 2018, which is to use pre-defined spreads for each security/instrument type to calculate the implicit costs of each transaction. This approach is similar to the PRIIPs methodology, but adopts pre-defined spreads rather than using an actual calculation of slippage based on order and execution prices. The results however are still varied, returning both positive and negative costs.

Unlisted investments

Within the industry there would appear to be a lack of clarity around transaction costs in relation to unlisted investments. The view appears to be that investments in unlisted securities do not incur slippage costs, (which we can understand given these investments will not be subject to a spread) and are therefore excluded from the slippage calculation. This contrasts with how costs are dealt with in relation to property purchases where Annex VI Part 1, paragraphs 19, 20, is applied by many in the industry. It would be useful to have some guidance and worked examples around unlisted securities in this context, clarifying where slippage can occur to ensure consistency across the industry.

Our view

Generally, our view is that slippage should be excluded from the regime as it is not a concept that many retail investors will be familiar with and as such we would question its value. It also seems counter-intuitive to calculate implicit costs, as the view amongst the industry is that these should over time net to zero. Additionally, we note that slippage is generally out-with

JOHNSTON CARMICHAEL

managers' control. Why not just exclude them in the first instance and restrict transaction costs to explicit costs of trading?

Q4: If you are an investor (or represent investors), what has been your experience with disclosures of transaction costs? Have you found these disclosures helpful in making your investment decision? Conversely, have you come across disclosures of costs which you found difficult to understand, or which you felt unable to rely on? Please provide supporting examples and evidence.

N/A– we do not have an investor's perspective.

Q5: Please provide your views, supported by evidence, on the SRI and on the extent to which the required and optional sections of the risk narratives enable the risks of a product to be adequately explained to consumers.

In our view, risk narratives and SRI do not sufficiently emphasise the risks associated with investment products. We have produced KIDs covering Investment Trusts, VCTs, REITs and Limited Partnerships and the range of SRIs calculated was limited. All products came out as a category 3 or 4. Most concerning was that VCTs typically were deemed a 3 and Investment Trusts a 4, which is not consistent with industry views on the risk of these products. Indeed, VCTs are defined as 'high risk' by the FCA.

This lack of differentiation in risk scorings is concerning, as results do not appear to accurately reflect the inherent product risk, particularly in relation to VCTs.

Standing back, based on our knowledge of the products, we would expect the SRIs to be higher than the calculated scores.

Additional narratives

Several of our clients have communicated that it has been helpful to have the additional 300 characters to elaborate on risks that are not captured in the standard wording. It would be helpful if future amendments to the legislation provided for a specific section for manufactures to include details on additional risks.

We also welcome the change made by the FCA in January 2018, whereby PRIIPs manufacturers are permitted to provide additional explanatory materials in conjunction with the KID, for example where the manufacturer feels that the performance scenario appears too optimistic.

JOHNSTON CARMICHAEL

Q6: Do you have any examples of products where the prescribed methodology for assessing and presenting risk leads to a counter-intuitive or potentially misleading SRI? If so, please provide examples.

SRIs in relation to Venture Capital Trusts

The prescribed method of presenting risk may be potentially misleading in relation to VCTs. VCT shares typically are sold through share issues, rather than secondary trading on the stock exchange. Limited trading on the stock exchange and share buy-backs lead to lower volatility, which under the current calculation, results in assignment of a lower risk score. We would agree with the view expressed by many others, that using NAV rather than share price would be a more appropriate input for VCTs.

The standard narrative as prescribed in the PRIIPs Regulatory Technical Standards for VCTs with a category 3 is: "This rates the potential losses from future performance at a mediumlow level, and poor market conditions are unlikely to [likelihood of payment]." Some of our clients have expressed surprise at this being the level of warning attached to their product on the basis that they do not feel it gives an accurate picture of the risk profile given VCTs typically invest in higher risk companies.

Time horizon for historic data

In addition, there is a question around the appropriateness of the time horizon used in the calculations. In general, approximately three years of share price data seems to be used in the calculation of SRI. In the context of investment analysis, this is a short time horizon. As markets have been strong in recent years with low volatility, this has been a significant contributory factor to overly optimistic SRI scores.

A cornerstone principle of investing is that "past performance is not a guide to future performance", however with heavy reliance on recent past performance in SRI and performance calculations, the PRIIPs regulations places too much reliance on past performance.

Q7: Have you experienced any practical issues with the calculation and presentation of performance scenarios in the KID? If so, please provide details so that we can identify any further practical difficulties not fully contemplated in our statement of January 2018.

Risk scenarios, time horizon and long-term market movement

In some instances, the stress/ favourable scenarios appear misleading. For example, a positive result may be shown after five years in an unfavourable scenario, suggesting that a given product is low risk. We note this has occurred in VCTs, Investment Trusts and REITs, which

JOHNSTON CARMICHAEL

are all products which are not without risk in unfavourable markets, when there would be a very real possibility that investors could lose money.

Data Source

As we understand the regulations, any reliable, reputable source of share price data is acceptable. There are several reputable industry sources, and we understand that in some instances, using different share price data sources can produce different results for the same product.

Considering this, we suggest that further guidance should be in place in relation to data source and perhaps KID manufacturers should be required to disclose share price data sources as part of the document.

Clients with mixed data – order, opening and execution price

Following on from our response to question three, where we discussed clients who had not captured order price prior to 2018 and who now do so, we have a practical challenge around how to deal with this going forward. For example, we may have clients who have three years of data to input into a KID calculation where two years of the data is based on opening and trade price and one year based on order and execution. It is not clear how best to proceed in these cases to ensure the most accurate presentation of information.

Interpretation of N in the stress scenario

On 16 August 2017 the Joint Committee of the European Supervisory Authorities (ESA) released a document providing expected calculation outputs for the Summary Risk Indicator (market risk and credit risk assessment) and Performance Scenario calculations described in the regulation, based on EuroStoxx data (ESA Q&A output).

We sought to recreate these numbers and noted the largest differences were in the stress scenario at recommended holding period 1 year and 2 years. This is driven by the interpretation of N in the stress scenarios.

Paragraph 9 of Annex IV of the Regulatory Technical Standards (RTS) sets out the formulae for the accumulation of the initial investment under the unfavourable, moderate and favourable scenarios. These formulae refer to N, which is defined as the number of trading periods in the recommended holding period.

Paragraphs 11 sets out the accumulation for the stress scenario, which includes a stressed volatility, wσs. The calculation of wσs is defined in paragraph 10.

Finally, paragraph 22 of Annex IV states that for Category 2 PRIIPs, the values to be shown for the intermediate periods should be calculated using the formulas in point 9 to 11 of Annex IV but with N defined to be the number of trading periods from the start date to the end of the intermediate period.

JOHNSTON CARMICHAEL

We used N as defined in the regulations, including allowing it to vary at intermediate periods, in the formulae in paragraphs 9 and 11, but not in paragraph 10 (i.e. not in the calculation of wσs.) For the calculation of Wσs, the model uses the number of historical observations instead of N.

By contrast, the results in the ESA Q&A document change N in all 3 paragraphs, including 10.

We believe that the mathematically appropriate approach to calculating the stressed volatility is to use the number of historical observations for two reasons:

- The stressed volatility is calculated by taking sample volatilities from historical observations. Regardless of whether we are calculating the projected fund values after 1 year, 3 years or 5 years, it makes sense to use all available historical data when calculating the stressed volatility. There is no mathematical reason to use a smaller data set just because we are projecting forwards over a shorter time frame.

- We believe the N used in paragraph 10 should be interpreted as the number of historical returns in the data set.

Otherwise, there are situations where the formulae as set out in the RTS do not make sense. For example, if a recommended holding period of 10 years was selected, paragraph 10 requires a sample volatility to be calculated for every historical return over a 10 year period this is impossible given that only 5 years' returns may be used in the KID calculations.

Following the publication of the ESA Q&A document, ESA delivered a presentation at a PRIIPs workshop on 27 November 2017. This presentation included further example calculations in which the stressed volatility is calculated using the same N for all holding periods. It is not clear whether the stressed volatility has been calculated using the number of observations in the RHP or the number of historical observations, however the fact that the same N has been used for all holding periods is consistent with our approach.

The existence of two conflicting approaches in the ESA illustrations means that the approach to take is currently unclear. However, the use of a fixed N is consistent with the more recently published illustration and, in our opinion, makes more sense.

Q8: Have consumers who are using KIDs to make investment decisions encountered any issues with the performance scenarios presented to them?

N/A – we do not have an investor's perspective.

JOHNSTON CARMICHAEL

Q9: Are there any other experiences with the implementation of (and compliance with) the PRIIPs legislation that you wish to raise with us? Please include evidence to support the points you make.

Methodology for calculating share price for new fund launches

In relation to newly launched funds, we note that the parameters for benchmarking permitted under the regulations are wide. This would appear to give manufacturers significant latitude in the formulation of SRI and performance scenarios. We suggest that consideration should be given to this process and the disclosures required on new launches, to ensure the information provided enables investors to make adequately informed investment decisions based on these documents.

Q10: As a user of the KID what is your overall experience of the information provided? Please provide examples of where the information received is useful in informing investment decisions.

N/A – we do not have an investor's perspective.