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Lord Forsyth of Drumlean
Chair, Financial Services Regulation Committee
House of Lords
Parliament Square,
London
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10 May 2024

Our Ref: 240430A

Dear Lord Forsyth,

Thank you for your letter of 30 April.

Investment trusts are a UK success story, playing an important part within our capital markets and providing investors with opportunities to gain access to illiquid, alternative asset classes.

We recognise that disclosure reforms are needed, which is why we took the rare action of issuing a supervisory forbearance statement in November 2023.

We are working closely with the Government as they consider the legislative steps necessary to enable us to put in place a new regime. We want to ensure that any replacement regime gives firms flexibility to communicate to investors in ways which recognise the differences between various investment vehicles and gives investors sufficient and meaningful information to inform their decision making.

Investment trusts reached their 10-year fundraising peak in 2021 with £14.6bn raised – according to the Association of Investment Companies (AIC), net demand for investment trusts reached an all-time high in 2022. Importantly, these successes came after the implementation of the packaged retail and insurance-based investment products regulations (PRIIPs) in January 2018, which introduced charge disclosure across the EU.

The sector has faced challenges in the most recent past, particularly in 2023. As interest rates have risen, demand for alternative asset classes, which historically provided higher-yields in a low-interest rate environment, has declined. I understand discounts having peaked last year have now declined somewhat as macroeconomic and market conditions have improved.

Given these wider and more fundamental challenges faced by the sector, we understand and appreciate the need to move as quickly as possible to address challenges created by the cost disclosure regime.

I turn now to your questions.

1. Can you explain why the FCA has made and sustained the decision to require investment trusts to be included in the cost-disclosure and aggregation format when no other country in Europe must do likewise?

I understand there are industry concerns that the UK is alone in its application of PRIIPs and MiFID to investment trusts when compared to EEA jurisdictions. We do not think this is correct.

When a retail consumer makes a direct investment into an investment trust the distributor must, under the PRIIPs regulation, provide a Key Information Document (KID). This includes information on costs and charges which is aggregated into an ongoing charges figure (OCF). Rules derived from MiFID also require the distributor to provide costs and charges information, including the costs and charges of underlying financial instruments. In the case of an investment trust, this would be the same information as is in the KID.

We understood that these rules were interpreted in the same way in other countries in Europe. But given the concerns raised, we undertook some analysis. This found that 60% of EU listed closed-ended investment companies, equivalent to investment trusts, were disclosing a non-zero ongoing charges figure. In other words, they were doing something similar to UK investment trusts, which suggests they are following the EU PRIIPs regulation. To understand this matter further, we have also engaged with regulators in other jurisdictions. The regulator of one significant fund jurisdiction in Europe, for example, confirmed that they currently treat Real Estate Investment Trusts as PRIIPs.

A separate concern has been raised about the aggregation of costs and charges in the context of investments by other funds into investment trusts. The concern is that the UK requires fund of funds that invest in investment trusts and their distributors to aggregate the underlying investment trust charges with fund of fund charges and that this is not consistent with Europe. We do not think this is the case.

Where such a fund of fund is distributed, MiFID II requires investment firms recommending or marketing an investment to provide the retail investor with disclosure of aggregated one-off and ongoing costs and charges relating to the financial instrument before point of sale (and if the firm has an ongoing relationship with the client, an annual disclosure of costs incurred).

Effectively this requires distributors to also use the PRIIPs figures in the listed closed-ended fund disclosure in heir own cost disclosures. Our interpretation of how MiFID requires distributors to aggregate is consistent with ESMA's guidance in this area.[1]

Given the concerns that have been expressed recently about the impact that aggregation of costs may be having on the market, we took the rare and unusual step of issuing a supervisory forbearance statement in November 2023 which confirmed that firms may provide disaggregated disclosure – in addition to the aggregate figures mandated through legislation – to enable investors to have a clearer understanding of the costs and charges involved so as to inform their own decision making on investment. That forbearance remains in force until such time as a new legislative regime is put in place – and we had widespread engagement with the Government, firms and relevant trade associations on the scope of the supervisory forbearance statement before it was finalised.

2. When was the inclusion of investment trusts in this format consulted upon, as it does not appear a straightforward requirement derived from EU legislation?

The PRIIPs Regulation is directly applicable assimilated EU Law. The scope of the regulation was decided by European legislative authorities. Industry has interpreted the scope of the Regulation as including close-ended investment companies,[2] and the AIC has consistently recommended that investment trusts show ongoing charges figures.[3] This is also our interpretation.

[1] ESMA35-43-349 Q&As on MiFID II and MiFIR investor protection and intermediaries topics (europa.eu), p. 82-83
[2] European Commission (2010), Consultation on legislative steps for the Packaged Retail Investment Products initiative
[3] AIC Ongoing Charges Calculation (theaic.co.uk)

The text of the PRIIPs consultation and of other preparatory materials from the European Commission show that the intention was to capture a very broad range of investment products being sold to retail investors and which involved indirect exposure to investment assets. This was said to include "all investment funds, whether closed ended or open ended, and all structured products, whatever their form (e.g., packaged as insurance policies, funds, securities or deposits)."[4]

To our knowledge the inclusion of close-ended investment funds (including investment trusts) within the scope of the PRIIPs Regulation has been generally uncontroversial throughout the European Union. For example, various Q&A and advice documents published by the European Supervisory Authorities (ESMA, EBA and EIOPA) reference closed-ended listed funds as intended to be in scope.[5] [6]

3. How is the FCA working on resolving the market disruption which has come as a result of the cost disclosure requirements?

We recognise that the PRIIPs framework has required the disclosure of costs that are not necessarily useful to end investors in assessing and comparing the value of a product. Some investment trusts have costs generated by servicing the underlying asset, as opposed to standard investment costs incurred by more traditional funds. For example, a property fund or renewable energy investment trust may have servicing costs associated with the real assets necessary to fulfil the investment strategy. These would not ordinarily be disclosed under a corporate structure.

The requirement to aggregate costs and charges into an overall figure has further exacerbated the challenge of accessing comparable charging information, particularly when the costs of underlying assets are then aggregated into other products, such as multi-asset funds. We are unable to exempt firms from having to provide an aggregated Ongoing Charge Figure (OCF) as the requirements currently sit in directly applicable EU law provisions the FCA does not have the power to amend. However, in recognition of the legitimate concerns that some of the costs disclosed under these requirements may lead to consumers receiving non-comparable information, we issued our supervisory forbearance statement last year.[7] This statement set out a forbearance approach to allow firms to better explain their costs to investors ahead of the replacement of EU law.

We intend to reform costs and charges disclosure as part of HM Treasury's Smarter Regulatory Framework. Change is required across several legislative files comprising assimilated EU law (MiFID, UCITS, PRIIPs) due to be repealed by the Government and replaced by domestic rules. We are working on a new disclosure regime to replace the consumer-facing disclosures required by the PRIIPs and UCITS regimes. We want to introduce a cohesive, effective and proportionate framework tailored to UK markets. We will be able to introduce a new regime following a consultation once legislation is passed under the Smarter Regulatory Framework.

4. Given the urgency of the situation, and your understanding that once the legislation is enacted, the issue will transition to the FCA's rulebook, when do you expect to launch a consultation on the changes to the cost-disclosure regime and can you take immediate emergency action?

[4] Ibid, at section 2.3. See also European Commission's Impact Assessment [SWD (2012) 187 Final] and Proposal for a Regulation of the European Parliament and of the Council on key information documents for investment products, 2012/0169.
[5] JC 2017 49 at page 55.
[6] Call for advice on PRIIPs: ESA advice on the review of the PRIIPs Regulation, JC 2022 20, 29 April 2022.
[7] Statement on communications in relation to PRIIPs and UCITS, FCA, 30 November 2023.

We are limited in our ability to act as PRIIPs requirements sit in underlying legislation, not our handbook. As noted, in November 2023 the FCA took action and issued a forbearance statement on the aggregation of costs and charges figures. Such a statement on legislation is rare and highlights our commitment to resolving challenges for the sector. This statement went as far as we reasonably could without legislative changes, as this is not a matter of simply waiving FCA rules.

I am aware that some industry bodies have called for a full exemption of investment from cost disclosures. We would have concerns about such an approach and wider impact on the market but recognise these are matters for the Government to decide.

We intend to consult on the details of the new regime by the autumn.

5. Could you confirm that once the statutory instruments are made, this issue will be solved?

The statutory instruments will repeal the relevant assimilated EU law and replace it with FCA powers to make certain rules. The FCA will then proceed to make rules that can effectively address these concerns, subject to our normal consultation process.

The FCA will consult on our proposed rules for the replacement Composite Consumer Investments (CCI) regime by the autumn. We have taken this situation very seriously and have undertaken work to evaluate and understand the changes needed to accommodate investment trusts as it is important to get it right. Our proposed new disclosure rules will be tailored to create bespoke rules to cater to the various products and investment vehicles, including investment trusts, while still ensuring consumers receive appropriate information about CCIs to allow them to make meaningful choices between investment opportunities.

In particular, the consultation will set out our intention to move away from the EU-inherited requirement to aggregate charges into a single figure which may lead, in some cases, to information that is not useful to investors. We intend for the new framework to support investors' understanding by providing them with information on comparable charges, so they know what they are paying for through the value chain. The requirements of our new regime will be tailored to reflect the specific characteristics of investment trusts and other investment options available to investors in the UK.

6. Could you provide examples of where the FCA has engaged with industry on this matter?

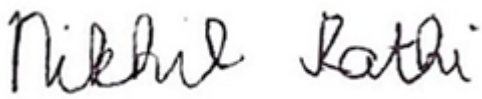
We have undertaken extensive engagement on this issue. For example, we spoke to a variety of firms and trade associations, convening a senior roundtable in October 2023, ahead of our forbearance statement to seek input on the scope of the statement to ensure that it addressed the concerns raised as far as possible. We are also engaging regularly with industry and with our statutory panels, such as the Consumer Panel and Small Business Practitioner Panel, as we seek to develop our policy thinking ahead of any future consultation once legislation is passed. For example, we have convened six group discussions and roundtable meetings between April 2023 and January 2024. These are in addition to the very many bilateral discussions we have had with individual firms and their trade body representatives, as well as engaging with interested parliamentarians.

7. What is being done by way of communication to regulated entities such as investment platforms and ACDs to alert them and ensure the data trail via the EMT is brought into line with the principles of the forbearance and to prevent further elaboration of wrongful cost explanations and delisting from platforms?

We understand that as of last week the European MiFID Template (EMT) was amended, and a revised version released to include additional disaggregated cost fields to accommodate our November forbearance action. The EMT is an industry owned and led initiative to allow for standardised distribution of product data from manufacturers to distributors. Under the Consumer Duty, platform firms should be determining value and listing for retail consumers on a holistic basis, rather than any single data line in the EMT.

I hope that this is helpful.

Yours sincerely,



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