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Lord Forsyth of Drumlean

Chair House of Lords Financial Services Regulation Committee

House of Lords

London SW1A 0PW 2 October 2024

Dear Michael

UK listed investment company cost disclosures – response to FCA evidence

I hope you are well.

I am enclosing a letter for the House of Lords Financial Services Regulation Committee, which has been compiled in response to evidence given to both your Committee and the Treasury Select Committee during the last Parliament, by the Financial Conduct Authority. In relation to the cost disclosure regulations imposed on UK listed closed-ended investment companies, it seems that there were some serious errors in the evidence provided to the Committees.

As you may know, I have been working with a large group of industry experts and a top legal team on this problem and we all feel that the record needs to be corrected, even though we are in a new Parliament. I enclose the submission for your consideration and information, which also includes a summary of legal analysis which has been prepared at some length with significant efforts from many of those involved. I feel it is important that the incorrect evidence given to and published by the Committee should not remain on the record unchallenged.

Those in this group would like their names to be kept confidential but if you do need further information or identification, please let me know.

I hope that you are able to circulate this to your Committee and would be grateful for your advice as to whether it is necessary or appropriate for me to also send the same to the new Treasury Select Committee, now that John Baron is no longer in Parliament?

Thank you for all the work your Committee has been doing.

Kind regards

Ros Altmann

Baroness Altmann

2 October 2024

FOR THE ATTENTION OF LORD FORSYTH OF DRUMLEAN, CHAIR HOUSE OF LORDS FINANCIAL POLICY REGULATION COMMITTEE

Submission Re: Response to FCA's statements regarding the nature and characteristics of London-listed closed-ended investment companies in the context of their cost disclosure obligations.

Firstly, we are writing to provide responses to the points made by the FCA on 8 May 2024 as part of Mr. Nikhil Rathi's testimony to the Treasury Select Committee and in the 10 May 2024 response to Lord Forsyth, Chair of the Lords Financial Services Regulation Committee.

Secondly, we would like to present the legal argument setting out the basis for re-interpreting the existing MiFID delegated regulation so far as cost disclosure in respect of London-listed closed-ended investment companies (LCICs) is concerned and de facto forbearance allowing investors to stop including costs/expenses of LCICs in their own reportable costs in the European MiFID Template (EMT).

I. Further information on the points made by the FCA to the Treasury Select Committee and the Lords Financial Services Regulation Committee

Industry participants disagree with some of the key statements that the FCA has made:

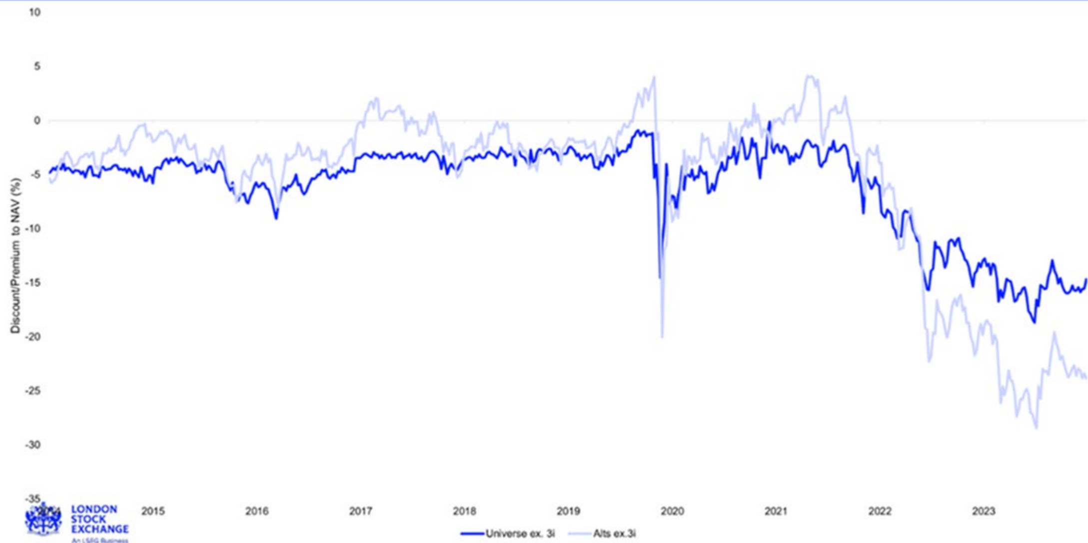
1. **The interpretation of the MiFID Annex Language on the EMT cost aggregation / What is the 'value of the investment'**
   - The FCA quoted an example of an LCIC whose portfolio is unchanged over a year but whose value is reduced by management fees. This is incorrect. Shareholders are only able to access the investment through ownership of shares, the price and value of which is determined by the market. The Net Asset Value, which is an indication of the underlying value of the assets held by each LCIC is inaccessible to shareholders and it is from the NAV that expenses are deducted. The Prospectus of every LCIC emphasises that an investor is not entitled to receive Net Asset Value.
   - Following investment, the share price suffers no deductions for costs or expenses. The share price is forward-looking and represents market participants' view of the present value of all future cashflows, including operating expenses and portfolio management costs.
   - MIFID regulations are clear that "ongoing charges" are those deducted from the value of the investment (Article 50(4), Annex II, Table 2). For any investment in a listed company the value of that investment is the share price.

2. The industry campaign supports transparency in disclosure

- Investment companies are subject to strict disclosure mandated in the listing rules and company law in the form of reports and accounts, with other prominent governance and accountability controls via Boards of Directors.
- Disclosure of costs should be presented in a form which does not mislead investors, as at present. The current methodology misleads investors to believe that LCIC costs are deducted once in the NAV and again as an ongoing charge taken from the value of the investment, in much the same way as with open-ended funds.
- Management expenses, including performance fees, and other recurring and non-recurring operating expenses of an LCIC are deductions from the NAV of the LCIC and not charges paid by an LCIC shareholder as a deduction from the value of the shareholder's LCIC shares. This characteristic of LCICs makes them different from open-ended investment funds and must be reflected in the making of rules, guidance, directions, policy or any other regulatory material and in the interpretation of legislation, including retained EU law.
- Furthermore, the industry has suggested a voluntary disclosure template (an enhanced version of the factsheet called the Statement of Operating Expenses) in alignment with the AIC methodology. This would surface the relevant information from the reports and accounts that will be decision-useful for investors.

3. Discounts have remained historically wide for a historically long period of time.

- The example used by the FCA to illustrate the aggregate discount affecting the UK's LCICs included a company which is not a constituent of the comparable universe, reflected by the fact it is not even a member of the AIC, is followed by equity investment funds and is <u>not</u> subject to cost aggregation by its investors. The company concerned was 3i (mkt cap £28bn), which would constitute 10% of the entire LCIC sector, if it were classified as an LCIC. The sector's statistics are customarily quoted ex-3i in acknowledgement of the distorting effect of 3i on statistics. We are concerned that the FCA's analysis of the state of the market in LCIC's is based on distorted data.
- Excluding 3i, sector discounts are marginally above their all-time wide at c.14% on average (and far wider for alternative asset strategies), which remain under continued selling pressure.
- 3i's costs are not aggregated by any funds in their OCF in the EMT, and the company's shares trade at a significant premium (40%). and hence it is necessary to exclude it from data showing persistent discounts.
- 3i publicly disclaims the wording of their own PRIIP disclosure and state that the KID requires the company to publish "results which, in 3i's view, could be misleading".



4. **The UK remains the only major jurisdiction that subjects listed companies to look-through aggregation of costs by their investors**

- The FCA has provided the following list of investment companies that report costs in the EMT database that they consider to be a comparable universe of investment companies:

	UK (inc Channel Islands / IoM)	EU	Rest of Europe
Total closed ended listed vehicles	416	20	38
With EMT cost data in Morningstar	367	12	16

Name	**Domicile**	**Listing**	**Legal Structure**	**Estimated Ongoing Cost**
CNI Nordic 5 AB	Sweden	Sweden	Closed Ended Investment Company	1.70
Coeli Fastighet I AB	Sweden	Sweden	Closed Ended Investment Company	1.24
Coeli Fastighet II AB	Sweden	Sweden	Closed Ended Investment Company	1.60
Coeli Private Equity AB	Sweden	Sweden	Closed Ended Investment Company	0.90
SBF Bostad A	Sweden	Sweden	Closed Ended Investment Company	1.63
SBF Bostad B	Sweden	Sweden	Closed Ended Investment Company	1.63
Skogsfond Baltikum AB (publ)	Sweden	Sweden	Closed Ended Investment Company	2.30
The Single Malt Fund AB (publ)	Sweden	Sweden	Closed Ended Investment Company	4.50
Zenith Venture Capital I AB (publ)	Sweden	Sweden	Closed Ended Investment Company	3.96
Greencoat Renewables	Ireland	London	Closed Ended Investment Company	1.21
BBGI Global Infrastructure Ord	Luxembourg	London	Closed Ended Investment Company	0.87

Fondul Proprietatea Ord	Romania	London	Closed Ended Investment Company	0.70

- 3 of these entities are UK listings: Greencoat Renewables, BBGI Global Infrastructure and Fondul Proprietatea and are therefore already included within the misleading disclosure regime in the UK.
- Of the remaining funds, two no longer trade. The remaining 7 entities have a total aggregate value of £125m (ranging from £4m to £68m). This universe should not be the basis for interpretation of the law in the UK's £300bn, 365 constituent market.
- The FCA has been provided with the evidence of how Switzerland (a non-EU jurisdiction that is subject to MiFID) treats all exchange-traded entities. Guidance in Switzerland states that "costs of companies listed on a public stock exchange are not costs considered as expenses for asset management" and clarifies further that investment companies are treated in the same way as other listed companies.

5. Broader macro conditions are not the sole cause of the sector wide discounts.

- Multi-asset investors continue to report outflows specifically from funds holding LCICs vs those that hold non-LCIC equities, despite positive LCIC NAV returns and asset sales at or above NAV. The average sector discount is now at -15% vs -4% in January 2022. The persistence of the discounts is out of line with other periods of crisis.
- NAVs have had a long period of time to adjust to the new higher interest rate regime, which is what has happened over the past 18 months. Indeed, in the recent reporting season there are growing examples of increased NAVs coming through, as they have already reflected higher interest rates and are now benefitting from positive influences from other factors, such as operational performance. The fact that discounts remain barely narrower than all-time wides indicates that there is another significant factor at play.
- It is acknowledged that other factors have contributed to the prevailing discounts, however market participants report very little support for LCIC's, of all types, be they REITs, alternative assets or equity, and a demonstrable lack of buy side support, due to excess reporting of costs.
- In the situation of broader macro uncertainty, we cannot afford not to fix a factor that is within our gift to.

6. **The FCA's Regulatory Forbearance of November 2023 was not sufficient.**

- The forbearance only addressed the aggregation of LCIC costs in the UCITS KIID and did not deal with the MiFID cost disclosure regime and its requirement for additional and duplicated publication of costs in the EMT. Whether published by investment firms in accordance with MiFID or published voluntarily by LCICs in order to be traded on investment platforms, a result was two different figures for ongoing charges to investors, in UCITS KIIDs and the EMT, causing considerable confusion.

II. The legal basis to address the ongoing breakdown of the Investment Company market ahead of the new legislation to replace PRIIPs

The trigger of the crisis

Whilst HM Treasury is working to replace the PRIIPs Framework with the new Consumer Composite Investments Regulations, the issue that could be addressed without new legislation is the aggregation of 'costs' for investors holding shares in LCICs, as published through the EMT.

It is important to stress that the ongoing breakdown of the market in LCICs was not caused by the PRIIPs disclosure, mandated in 2018, i.e. before the sector's new records in capital raising activity. The trigger of the crisis was The Investment Association's deadline of June 2022 imposed on its members for complying with cost aggregation on a look-through basis, which has rendered LCIC shares uninvestable as an asset class. This is clearly evidenced by the almost immediate cessation of fundraising activity by companies in the LCIC sector, despite other equity raising continuing.

Current MiFID requirements

MiFID rules only require the aggregation of costs that are deducted from the value of the investment. As is the case with any exchange-traded company, the value of that investment is the market-determined share price, and LCIC costs and expenses are factored into the market price of the shares and are not deducted from the value of a shareholder's investment. Shareholders are only able to access the investment through ownership of shares, the price and value of which is determined by the market. The existence of the share price makes a closed-ended investment company different from the open-ended structure, where costs and expenses are charged separately to the investor's share of NAV and detract from the value of the investment.

The requested re-interpretation by the FCA does not require legislative change, as is evident from the subsequent withdrawal of the original IA Guidance on 30 November 2023. A purposive interpretation would be in alignment with other jurisdictions subject to MiFID, such as Switzerland where costs of all listed companies are excluded from investors' asset management costs. Please refer to the Annex for the short form legal argument explaining the definition of "value" in the context of a listed company, prepared by Herbert Smith Freehills LLP.

Annex

Pursuant to Article 50 of the UK version of Commission Delegated Regulation (EU) 2017/565 ("**the MiFID Delegated Regulation**"), investment firms are required to disclose certain information on costs and associated charges to their retail and, in certain cases, professional clients.

Under Article 50(2) of the MiFID Delegated Regulation, for ex-ante and ex-post disclosure of information on costs and charges to clients, investment firms are required to aggregate the following:

"*(a)* *all costs and associated charges charged by the investment firm or other parties where the client has been directed to such other parties, for the investment services(s) and/or ancillary services provided to the client; and*

(b) *all costs and associated charges associated with the manufacturing and managing of the financial instruments.*"

Costs referred to in points (a) and (b) above are listed in Annex II to the MiFID Delegated Regulation. Table 2 in Annex II, extracted below (highlighting added), sets out the costs and associated charges that should form part of the amounts related to financial instruments that should be disclosed under point (b) above:

Table 2 — All costs and associated charges related to the financial instrument that should form part of the amount to be disclosed

Cost items to be disclosed		***Examples:***
One-off charges	*All costs and charges (included in the price or in addition to the price of the financial instrument) paid to product suppliers at the beginning or at the end of the investment in the financial instrument.*	*Front-loaded management fee, structuring fee, distribution fee.*
Ongoing charges	*All ongoing costs and charges related to the management of the financial product that are deducted from the value of the financial instrument during the investment in the financial instrument.*	*Management fees, service costs, swap fees, securities lending costs and taxes, financing costs.*
All costs related to the transactions	*All costs and charges that incurred as a result of the acquisition and disposal of investments.*	*Broker commissions, entry- and exit-charges paid by the fund, mark ups embedded in the transaction price, stamp duty, transactions tax and foreign exchange costs.*
Incidental costs		*Performance fees*

This application of the costs aggregation requirements results in the disclosure of artificially high ongoing charges figures ("**OCFs**") in respect of LCICs.

Costs incurred by LCICs such as those mentioned in Table 2 copied above should not properly be counted as costs and charges that "*are deducted from the value of the financial instrument*". The value of the financial instrument, in the case of a share in an LCIC, is the share price, which is derived from a range of factors, including (though not limited to) the ongoing costs incurred by the

LCIC. Such costs are therefore already factored into the value of the share and are not "deducted" from that value. The same is true for performance fees, and the row of Table 2 dealing with "Incidental Costs" should be interpreted in the same way.

This is contrasted with the ongoing costs of open-ended funds, whose shares are redeemable at the NAV per share which, accordingly, is the value of the financial instrument to the investor. The costs paid by an open-ended fund are deducted from its NAV and, therefore, from the "value" of such shares.

A sensible reading of the above described MiFID Delegated Regulation costs aggregation and disclosure requirements in respect of LCICs would not require the aggregation of the ongoing costs of the LCIC and instead would allow firms to disclose the Ongoing Cost Figure for LCICs as 'zero'.

Summary of the detailed argument justifying a zero ongoing costs and charges figure in MIFID II Delegated Regulation costs disclosure in respect of Listed Closed-ended Investment Companies (LCICs)

A key objective, or purpose, of the MiFID II Disclosure Regime, and the Delegated Regulation in which the detailed costs disclosure requirements are located, is to inform investors of the costs of investment that they will actually incur in a manner which is fair, clear and not misleading. As regards ongoing costs, the requirement is to disclose "all ongoing costs and charges related to the management of the financial product **that are deducted from the value of the financial instrument** (our emphasis)".

The value of the relevant financial instrument under consideration and the ongoing costs and charges to be deducted from that value must be determined in a manner which takes into account the key characteristics of the relevant financial instrument which an investor would experience. Where that financial instrument is a share in an LCIC which is publicly traded and has a price determined by the stock market on which it is traded, that share price must be taken to be the value of that financial instrument. The share price is what an investor pays for the share and there are no ongoing costs or charges deducted from a share price, which already factors in relevant costs and charges to be borne by the company. Disclosure of ongoing costs by reference to the figures contained in a PRIIPS KID, which implies that investors will incur costs which are additional to those incurred by the LCICs themselves, gives investors the misleading impression that they will incur greater costs associated with investment in LCICs than is actually the case.

The legal basis for interpreting the undefined term "value" to mean "share price" rather than "net asset value" is threefold: literal, purposive and contextual.

Literal: although a construct such as net asset value/gross asset value is widely used in the asset management industry, in the context of a regime concerned with ensuring communication to investors of the true worth of their investment after taking account of all costs associated with it, the word "value" should be given its natural dictionary meaning – its money's worth in the hands of a seller or buyer. A share publicly traded on a stock market is worth its stock market-determined share price. This interpretation is in line with numerous other provisions of the legislation.

Purposive: as it is retained EU legislation, the Delegated Regulation must be interpreted purposively. This requires an interpretation which serves the legislation's purpose of introducing transparent, clear, fair and not misleading disclosure of the costs and charges an investor will actually incur and which would affect the realisable value of their investment. It must follow that the legislation cannot properly be interpreted in a way which results in an overstatement of those costs and charges and/or presents them in a misleading manner. Expressed in a different way, if there is one interpretation which results in costs and charges being fairly disclosed, with no suggestion of misleading overstatement or double counting, and another which results in misleading disclosure as a consequence of overstatement then one must surely conclude that the legislation was intended to be interpreted in a manner consistent with the former result and not the latter. It follows that only ongoing costs and charges which detract from or erode the amount which an investor would realise from the relevant financial instrument – in this case eroding the realisable stock market value – should be disclosed. The PRIIPs KID-derived ongoing costs and charges do not erode that realisable value since they are already factored into it, and accordingly should not be disclosed as costs to the investor – the investor will sell or realise the share price.

Contextual: the value of a financial instrument for these purposes cannot properly be determined in an abstract or generalised manner; it must take account of the instrument's essential characteristics. Similarly, any ongoing costs and charges to be taken into account must be costs and charges that an investor will actually incur. It may be that for other types of financial instrument a standard methodology based on net asset value/gross asset value and reflecting the costs and charges payable out of that net asset value is appropriate. For an investor in an LCIC, however, the key determinant of value is the share price, and this must be recognised rather than ignored. This characteristic distinguishes LCIC shares from financial instruments which are not publicly traded and hence requires a departure from any standard methodology which would not otherwise reflect it and the adoption of the market-determined share price as the value of the financial instrument.