<u>Response to FCA consultation on MiFID Org Reg CP24/24</u>

From: London Stock Exchange PLC, Baroness Bowles of Berkhamsted and Baroness Altmann

We agree to publication of our names.

Summary

Listed closed-ended investment companies should not have been included in MiFID Regulations, especially for so-called ‘cost’ disclosures. These ‘costs’ are paid by the company, as are the expenses of other listed operating companies, and not charged directly to shareholders.

The persistence of confusion between the investment value of closed-ended and open-ended funds, has created significant market disruption and selling pressure in UK-listed closed-ended companies. The Government has sought to remedy this with emergency guidance and a new SI, which sought to unwind the conflation of costs of open-ended funds that are paid by investors directly, with the expenses borne directly by a closed-ended company and not passed directly to shareholders.

The original inclusion of closed-ended companies in MiFID was the result of an attempt to help investors compare the value of open-ended and closed-ended funds, in an era when many open-ended funds did not fully disclose all the costs that would be paid directly by unit-holders/shareholders as regular deductions from the Net Asset Value (NAV) at which their investment was priced. The costs of management, administration, accounting, legal fees and so on, were not always fully disclosed. However, with a closed-ended listed company, all such expenses are fully disclosed in the Annual Report and Accounts which are required by the Listing Rules and these are not directly charged to investors, even though they may be reported or paid by the company as a proportion of the company’s NAV (as with other quoted operating companies).

The market mechanisms of share price (which is the value of an investor’s holding in that company) and the listing rules, make a closed-ended investment company fundamentally different from open-ended fund structures, whose costs and expenses are directly charged to the investor’s share of the NAV, directly reducing the value of their investment holding.

In 2022, rules made for open-ended funds were unfortunately applied to disclosures for closed-ended companies listed on UK markets (interestingly, other jurisdictions in the EU had not applied these MiFID rules to their listed investment companies). Investors have been told they will suffer direct deductions from their market share price, which is simply not correct – and indeed technically impossible. Retail investment platforms have been showing 5-year value illustrations which are highly misleading as they suggest shareholders will pay significant costs out of their investment value (the market share price) each year, which they do not actually pay.

Naturally, this has led to ongoing selling of closed-ended company shares and a widening of discounts to NAV, that has effectively blocked this sector from raising new capital and undermined its competitive position both domestically and internationally.

The Government and FCA recognised these issues in the Autumn with interim legislation and forbearance. It was not enough to restart the market because there is investor uncertainty going forward and some key investor platforms have not allowed necessary presentation changes.

However, the CCI consultation from the FCA, seems to risk a repeat of the past errors and have some perverse proposals such as reinstating aggregation for closed-ended investment companies (which have nothing to aggregate) and excluding aggregation in instances where it is relevant.

This is the time to correct the market misperceptions and regulatory confusion, between consumer 'costs' of open-ended funds and corporate expenses of closed-ended funds. This response to the consultation seeks to assist in clarifying the situation. Both Baroness Altmann and Baroness Bowles have laid Private Member's Bills which sought to achieve this. The market situation for closed ended UK listed companies has continued to deteriorate – forcing buybacks, preventing new fundraisings, attracting hostile bidders from overseas and creating investor losses, based on a false premise or misunderstanding.

1: Do you agree with our approach to restating obligations from the MiFID Org Reg into our Handbook?

<u>Disagree</u> because additional clarifications should be included before restating Articles 50 and 51.

Two initiatives should be prioritised as a matter of urgency with regard to listed closed-ended investment companies (LCIC).

1. Maintenance of the amendment to the MiFID Org Reg which deals with aggregation. This is because there is no cost deduction from share price, which is the value owned by the investor be that a retail client or open-ended fund, there is nothing to aggregate.
2. Recognition of the fact shareholders do not bear any direct costs of holding/managing these shares i.e. there is no deduction from share value in all the descriptions made by distributors, in particular by investment platforms, which can be done by the FCA issuing a clarification of the meaning of 'value' in the MiFID Org Reg.

While there is overlap with CP24/30 on CCI, the FCA should use all opportunities to address the continuing provision of misinformation that is being given to consumers and causing market disruption. **The FCA has now publicly confirmed the factual situation that there are no deductions from share price of listed closed-ended investment companies. That should be acted upon wherever possible**.

Insofar as Article 50 and 51 are concerned in addition to the amendment made in SI 2024 No 1204 The Packaged Retail and Insurance-based Investment Products (Retail Disclosure) (amendment) Regulations 2024 efforts should be made to explicitly state that in **all** ownership scenarios there are no deductions from 'share price' (ie the investment value) for closed-ended Listed Investment Companies.

This underlies the SI amendment made regarding aggregation and should be clarified for individual ownership of closed-ended listed investment company shares given the ongoing confusion in the market and investment platforms refusing to accept that the OCF figure is zero when it is described and/or illustrated as showing (untrue) deduction from share price. Suitable changes must be made in COBS.

The amendment

The Packaged Retail and Insurance-based Investment Products (Retail Disclosure) (Amendment) Regulations 2024

Amendment of Commission Delegated Regulation (EU) 2017/565

3.—(1) 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 and defined terms for the purposes of that Directive(**5**) is amended as follows.

(2) In Article 2 (definitions), after point (16C) insert—

> "(16D) "closed-ended investment company that is UK-listed" is to be interpreted in accordance with Article 2(3) of 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;".

(3) In Article 50 (information on costs and associated charges), in paragraph 2(b), after "instruments" insert ", except any corporate expenses paid by the company, not charged directly to shareholders, of manufacturing and managing shares in a closed-ended investment company that is UK-listed".

(4) In Article 51 (information provided in relation to units in collective investment undertaking or PRIIPs)—

(a)the existing text becomes paragraph 1;

(b)after that paragraph insert—

> "**2.** The requirements in paragraph 1 do not include any corporate expenses borne directly by the company of manufacturing and managing shares in a closed-ended investment company that is UK-listed."

Need for more clarification

The CCI consultation CP24/30 in paragraph 5.44 says 'Some products, such as investment companies, deduct costs from the Net Asset Value (NAV) of the investment and not the share price.' This wording continues the confusion that has pervaded the UK financial markets and media, which suggests investors need to be concerned about comparing costs they bear directly for owning an investment, with the expenses (costs) paid by the company itself and reflected in the share price.

In the above 'investment company' means a closed-ended investment company that is UK listed and though clumsily worded it expresses the fact that share price owned by the investor cannot have deductions made to it and the share price is already an 'all in' market view of value. The fact that there are no deductions from share price for closed-ended Listed Investment Companies was confirmed by the Chair of the FCA to the Lords Financial Services Regulation Committee and indeed also acknowledged more recently by officials in meetings with industry regarding the CCI consultation.

But this is not made clear or properly taken into account in these Consultation Documents for PRIIPs and MiFID.

There are extensive transparency requirements in legislation surrounding all listed companies (Prospectus, Transparency, Company Law) which mean that all the information must be disclosed and any so-called 'cost disclosures' (which are really 'expenses' paid by the company and not charged direct to shareholders) are not about new disclosures of things that have been hidden, but about showing already available information in a convenient form at point of sale. Unfortunately, due to the jargon use of the term 'costs' it has led many consumers and others into thinking there would be, or had been, a lack of transparency. Indeed, and as acknowledged in CP 24/30, it was already the case that for closed-ended listed investment companies, summary information (ie repeated information) was also voluntarily made available at point of sale before the introduction of legislation.

Unfortunately, the rigid (and in our view incorrect) interpretation of the MiFID Org Reg and PRIIPs, which has confused corporate expenses with direct deductions from shareholders investment value in open-ended structures, has led to a substantial dislocation in the market and almost complete stalling of new investment for three years. This has harmed investors because it has struck at liquidity and increased discounts and potentially led the UK to miss out on the opportunity of securing tens of billions of new investments into real assets such as infrastructure.

Further detail

MiFID rules require the aggregation of costs that are deducted from the **value of the investment. For listed closed-ended investment companies, this means the share**

price. As is the case with any exchange-traded company, the value of that investment is the market-determined share price and listed closed-ended investment companies' costs (more properly described as company expenses) are factored into the market price of the shares and are not deducted from the value of a shareholder's investment which is the shares at market price.

Shareholders are in fact only able to access the investment through purchase of shares, the price and value of which is determined by the market taking all factors into account. This is why there are such stringent rules about information disclosure to the market for all listed companies (commercial and investment). Furthermore, when shares are purchased in the market they already have known projected corporate expenses (costs) discounted in the share price and that is one of the reasons that (prior to this cost disclosure crisis) many had steady state small discounts, but all other information and sentiment (the wisdom of the market) is rolled up together in the share price.

The existence of the share price **and listing** makes a closed-ended investment company different from the open-ended fund structure, where their costs and expenses are charged to the investor's share of NAV and are thus a direct deduction from the value of the investment.

In 2022 rules made for the open-ended situation were applied to the closed ended companies market share price, with investors being told that they will suffer actual deductions from their market share price which is inaccurate (not to mention technically impossible) and even now investment platforms show 5-year value illustrations that are many hundreds of pounds incorrect, dangerously misleading investors.

There are various analogies that can be applied. It is like buying an all-in holiday and then being told you must pay for the flights. Or it is like comparing a fresh pear and a tin of pears but saying you must use the fresh pear shelf life ignoring the tinning phase. It is simply wrong. Nevertheless, platforms still say this is what the legislation mandates and are fearful about Consumer Duty (although that should imply tell the truth) largely because the FCA has not made any correction or direction about that interpretation, unlike other countries.

Re-interpretation/clarification by the FCA does not even require legislative change. A purposive interpretation would be in alignment with other jurisdictions subject to MiFID, such as Switzerland, where regulators have explicitly stated that corporate management expenses, which the UK has incorrectly labelled as consumer costs of all listed companies are excluded from investors' asset management costs. The annex below gives a short form legal argument explaining the definition of "value" in the context of the MiFID Org Reg and a listed company, prepared by Herbert Smith Freehills LLP. This legal argument was presented in written evidence by Baroness Altmann to the Lords Financial Services Committee and has been published on the Committee website.

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'.

<u>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)</u>

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.