UK Listed Investment Companies / Closed-ended Funds - FAQs re Cost Disclosure

Which parts of law/regulation are causing issues for listed investment companies?

The damage to this strategic area of the market stems from:

1. **standardising regulatory disclosure for structurally different entities** a) listed closed-ended investment companies/funds (that are traded at a market price, that by definition reflects the costs/expenses of running the company) and b) open-ended funds (that are held and redeemable at NAV less ongoing costs and charges). This disclosure was imposed under the EU-derived PRIIPs regime (soon to be replaced with a new 'Consumer Composite Investments' disclosure regime). The outcome is a **misleading presentation of internal expenses of investment companies in PRIIPs KIDs**, that are wrongly presented as costs payable by investors.

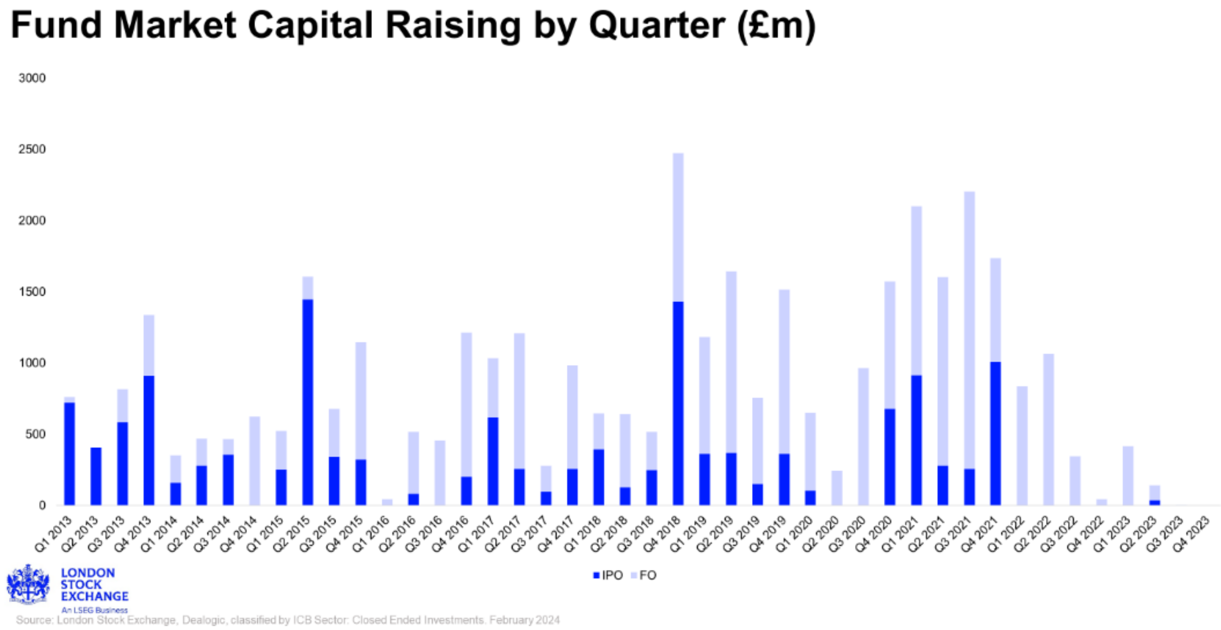
2. **the UK's interpretation of the MiFID II regulation** as reflected in the Investment Association's guidance of January 2022 with the compliance deadline of June 2022. The guidance required multi-asset investors to publish an aggregate cost figure in the European MiFID Template that includes any internal expenses of investment companies held in multi-asset portfolios on a look-through basis, despite these expenses already being reflected in the market price of investment companies (as is the case with any other listed company). The outcome is a misleading, inflated and untransparent single cost figure in the European MiFID Template that investors have to produce, making investment companies look expensive to hold.

Put simply, the UK now requires investors in these listed companies to report the operating expenses of these companies in their own reports to their clients as though they were their own fund management costs. These operating expenses are already baked into the share prices of those investments. As such investors are required to double count the costs of investing. And rather than do that, they simply sell the shares of investment companies. The consequent flight of capital is a disaster for the very sectors the government wants the private sector and pension funds to support. And this cost reporting requirement is fundamentally misleading and out of alignment with any other country in the world. No other country treats any listed company this way.

What is the evidence of the market harm?

An abrupt decline in the ability of listed investment companies to raise primary capital, as evidenced by lack of IPOs and rapidly declining follow-on offerings from the date of the enforcement of the IA guidance on cost aggregation. The London Stock Exchange is in receipt of continuous feedback from investment banking advisers and other market participants as to the reasons for the inability to obtain investor allocations for IPOs or follow-on offerings. The disinvestment triggers illiquidity, volatility and unprecedented discounts to audited NAVs industry-wide. Anecdotal evidence suggests that multi-asset funds with no investment company holdings are getting 10 times the inflows versus those that do because of the high aggregate cost figure they have to report in the EMT and the implementation of the Consumer Duty.

Even during the years of the pandemic, we did not see such low levels of capital raising activity. In the aftermath of the financial crisis, we witnessed a quicker recovery and sustained fundraising in this sector. Normally, this market accounts for over a third of the primary market activity in the UK, but since June 2022 that number stands at less than 7%.



In this graph you can observe the immediate impact to IPO and Follow On offerings following the IA's January 2022 guidance

The ability to raise further capital is integral to the ability of existing listed investment companies to implement their stated investment strategies. The outcome of the current disinvestment is an abrupt termination of portfolio allocations from this sector to strategically important industries, such as energy transition, infrastructure, innovation-driven sectors and private companies more broadly.

What is the basis for the industry to seek the exclusion of LCICs from the new CCI regime replacing the retained PRIIPs regime?

The joint response to HM Treasury's consultation on the draft Consumer Composite Investments (Designated Activities) Regulation 2024, submitted on 10 January 2024 by the London Stock Exchange on behalf of industry stakeholders, presents a clear argument for the necessity of urgent reform. The signatory list includes 329 signatories, including 186 firms, many of them members of the IA that invest in LCICs as part of their multi-asset strategies, as well as cross-party parliamentarian supporters. The response urges the exclusion of listed investment companies from the proposed CCI disclosure regime on the basis of:

1. **Definition of a CCI**. The SI defines a CCI as an investment where the "amount repayable [to the investor] is subject to fluctuations because of exposure to … the performance of one or more assets…". In the case of publicly traded/listed closed-ended investment companies, which invariably have unlimited lives, there is no amount repayable to their investors in the sense of the investor being entitled to be repaid any amount on a given date either because the shares have a fixed duration, or the investor has a right to require redemption. In the ordinary course, therefore, investors can only realise their investments through a sale of their shares on the stock market at the prevailing market price, rather than by being repaid any amount by the LCIC.
2. **Existing disclosure regime.** Listed investment companies are already subject to a robust regulatory disclosure regime through a combination of company law and the various legal and regulatory requirements relating to prospectuses, financial reporting, financial promotions and the listing, transparency and other rules relevant to the market on which their shares are traded.

As a consequence of being treated as excluded products, listed investment companies will not be required to comply with a cost disclosure regime which is misleading in the way in which it explains 'costs'; but they will still provide the requisite transparency and detail as to their internal expenses as a result of those other legal and regulatory requirements.

3. **Non-harmonised treatment of UK listed companies with established observable international market standards.** Only UK listed investment companies are required to produce a PRIIPs KID, in which their internal expenses are portrayed as product costs, with these expenses aggregated into a single cost figure by investors. For example, Irish domiciled REITs have not been considered to be PRIIPs due to the closed-ended nature of these entities, with no amount repayable to the investor. Evidence of the Irish (and we would assume other countries') approach can be seen from analysis of EMT disclosures and the ongoing charges figure (OCF), where only UK-listed investment companies show a non-zero OCF. Only the UK has enforced this aggregation against institutional multi-asset investors. The selective inclusion of 'product costs' relating solely to public companies listed in the UK in aggregated portfolio costs and charges disclosures creates a range of perverse incentives and adverse outcomes that run contrary to the statutory objectives of UK regulation, including undermining fair competition, providing misleading information to consumers, and damaging market integrity.

How will the necessary level of transparency be achieved outside the regulated disclosure regime?

A group of industry participants have put forth new proposals for clear, transparent and fit-for-purpose disclosure for listed investment companies in the form of a 'Statement of Operating Expenses' (SOE). The proposed SOE would disclose expenses of running a listed investment company, as distinct from an open-ended fund. The SOE would surface all the appropriate expenses, taken from audited accounts, in a way that <u>improves</u> transparency and consumer understanding of these companies. This proposed disclosure is <u>fully in-line with existing AIC guidance</u> of what ongoing charges (as they are currently called) should include.

In addition, listed investment companies are already subject to a robust regulatory disclosure regime through a combination of company law and the various legal and regulatory requirements relating to prospectuses, financial reporting, financial promotions and the listing, transparency and other rules relevant to the market on which their shares are traded. Listed investment companies also publish regular investor updates or factsheets in which expenses are displayed in accordance with the AIC (Association of Investment Companies) methodology.

With the abolition of the PRIIPs KID, market participants, keen to ensure transparency of information for investors have created a new document, currently called the Statement of Operating Expenses and work is nearing completion on tailor-made documents for listed ICs that include operating expenses which are available at point of sale.

The sector is united in calling for greater levels of accurate transparency. The contention is that the aggregation of costs which are distributed market wide through the European MiFID Template (EMT), actually does the opposite and leaves the investor with less information than is desirable. Simply adding underlying and irrelevant expenses has proved to be a significant headwind to investor appetite and has led to misinformation in circulation for investors of all levels of sophistication.

What is the EMT and what is wrong with the disclosure in it?

The EMT is an excel spreadsheet template, implemented by a group of regulators and industry bodies in Brussels which is designed to give a standard and voluntary method of distributing information to all market participants including software vendors (providing pricing information), platforms and administrators. The template is free to download, and has pre-determined cells, into which both static and dynamic information can be manually entered. It is then distributed market wide to ensure consistency of information is available to all.

The EMT consists of 104 static cells, two of which require the 'costs' of London only, listed investment companies to be added to the data feed. Their costs are received by the distribution services (data vendors and platforms) and added to the apparent cost of ownership. This is an error and has led to significant misinformation being distributed market wide. The expenses referred to above, should not be added to this template, in which they are aggregated and published. Closed ended listed companies do not have costs which impair the investment performance of the company. Open ended funds, however, do have costs which impact performance. It is therefore argued that the costs of open-ended funds should continue to appear in the EMT, but that Closed ended companies should be removed.

Why is the IA support needed urgently?

The absence of consolidated action from the regulators and the industry bodies to examine and mitigate this decline over the past two years has led to widespread failure in the market of these listed companies and has undermined confidence in the robustness and effectiveness of the regulatory oversight.

Some steps have recently been taken with a view to resolving these issues. But this did not go far enough. The IA amended its January 2022 guidance on 30 November 2023 to remove its recommendation to aggregate investment company expenses in fund costs disclosures in UCITS KIIDs.

The issue persists both in disclosures in UCITS KIIDs (where compliance departments of asset management firms have continued to follow the previously stated approach, which they had been told is the conservative and Consumer Duty aligned interpretation) and in disclosures in European MiFID Templates (**EMTs**) and PRIIPs KIDs (where the guidance and rules are yet to catch up). This has resulted in even greater confusion about the appropriate approach, as well as potential conflict between the ongoing costs figures disclosed to consumers in different documents.

What is the opportunity currently available under existing MiFID rules (requested to be addressed by the IA)?

There is a clear legal basis exists for the IA to issue (and the FCA to endorse) an immediate statement clarifying that its members can stop aggregating company-level expenses of investee LCICs with the costs of the fund investing in them. This basis has existed all along in the MiFID Org Regulation. Article 50(2) of that Regulation provides that:

> 50(2) "*For ex-ante and ex-post disclosure of information on costs and charges to clients, investment firms shall aggregate the following:*
> - *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 service(s) and/or ancillary services provided to the client; and*
> - *All costs and charges associated with the manufacturing and managing of the financial instruments*

Annex II, Table 2 of the MiFID Org Regulation, replicated in COBS 6 Annex 7 Table 2, sets out more detail on this requirement under part (b), as follows:

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.*

The provisions above should, in HM Government's view, be interpreted to mean that LCICs do not have ongoing costs that meet the definition to be included in costs aggregation. The ongoing expenses of an LCIC are not 'deducted from the value of the investment' in the same way as they are for an open-ended fund. The value of the investment in an LCIC is the company's share price, not the NAV of the underlying investments. In the same way as the recent IA guidance has addressed the removal of the 'costs' of LCICs from UCITS KIIDs published by open-ended funds, the IA is being requested **to issue guidance to clarify that the figure for costs of LCICs to be aggregated for the purposes of MiFID EMT disclosure should be zero, and for the FCA to endorse that guidance.** This guidance and its endorsement by the FCA would address the issues relating to the EMT and will start the process of restoring the flow of capital and investor access to important sectors of economic activity, as well as restore confidence in the regulation of this strategic area of our markets.

Why is the Government undertaking an urgent intervention?

The sector has suffered a steady and rapid decline over the past two years in the absence of consolidated action from the regulators and the industry bodies to examine and mitigate this decline.

Removing the misleading elements of cost disclosure should be the first step in restoring capital raising opportunities for companies in the sector and investor access to the underlying areas of economic activity.

HM Treasury intends to amend the MiFID disclosure framework to clarify what HM Government considers to be the correct interpretation of the current legislation. However, it will take some time for HM Government to finalise the intended legislative amendments, pending which the problems and the consequential damage to the industry continue.

In light of the focus on Consumer Duty, the removal of misleading presentation of costs in the EMT will enable investors to be undertaking a balanced approach that captures the potential returns and subsector exposure available through investment in listed investment companies.

Why are you seeking a different treatment for closed-ended funds vs ETFs?

ETFs are open-ended entities that create and cancel shares on a daily basis, with the investment redeemable at NAV.