ITG® CSS Compliance Solutions Strategies

A Year On: Transaction cost reporting under PRIIPS and MiFID II

In the runup to 1 January 2018, financial firms the world over rushed to select service providers for the various tools required to comply with PRIIPS and MiFID II. Decisions were not necessarily made with validation that the products, vendors or data sources they had selected were indeed best-suited to the firm's needs, but rather with the goal of ensuring that the selected solution allowed the firm to "check the boxes" related to the RTS.

A year on, firms are rethinking some of those decisions. While many of their selections will be fine for the time being, others turned out to be underwhelming, if not altogether vaporware. Still others were Band-Aid decisions that were suitable for the immediate need, but not the long term. Transaction cost calculations are proving to be a notably affected area, with a surprising number of clients rethinking their product selection, particularly as costs and charges transparency and regulatory audits make headlines.

Regulatory Recap

The EU PRIIPs regulation went into effect in 2018. It covered, among other areas, the disclosure of costs and charges associated with an investment in Packaged Retail and Insurance-based Investment Products. The regulation states that transaction costs must be disclosed in a key information document (KID).

In addition to the PRIIPs regulation, MiFID II introduced new obligations on firms acting as product manufacturers and distributors. Since the beginning of 2018, distributors and advisors who provide services have been required to disclose information about all costs and charges within the funds they offer to their clients, including transaction costs. Under PRIIPS, product providers are required to support distributors in fulfilling their obligations by disclosing relevant cost information. Similarly, MiFID-regulated asset managers are required to provide information about all costs and charges incurred for the portfolios they manage, both for their retail and professional clients.

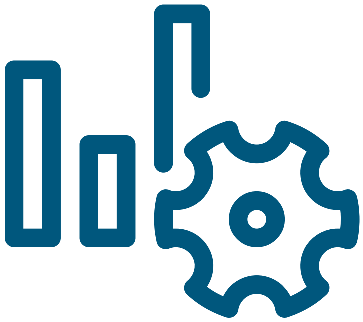
Firms that manufacture financial instruments (such as asset managers) need to provide distributors with a functional description of the minimum set of data to help them fulfill the new regulatory requirements. This information includes defining a financial instrument's target market and disclosing its costs and charges. Failure to do so could result in stopping a fund from being sold, the imposition of regulatory fines and, more drastically, a firm's suspension.

Guidance (Q&A) published by ESMA and the Joint Committee of European Supervisory Authorities has provided new insights on the implementation of the rules, but very little has changed in the realm of cost calculations. In addition, the UK Financial Conduct Authority launched a consultation on PRIIPs, whose results will be made available this year. There is still discontent in the industry regarding the way the rules were implemented, and further changes could be proposed for 2019 and beyond. The FCA also indicated that its inspections of edge-case data found the root cause of extreme outliers was in nearly all cases poor quality data or failure to apply the stated algorithm correctly.

Cost Calculations

For many firms, transaction cost calculation requirements were among the last they addressed when it came to preparation for PRIIPS and MiFID II. This was especially true among firms that already had TCA providers in place, under the assumption that this area was being addressed by their existing provider. Compliance teams expected the numbers published by their provider simply to carry over to their EPT or EMT templates. In reality, however, the "portfolio transaction cost" calculations as specified in the EU PRIIPs regulation are different from the standard TCA methodologies and quite complex.

First, all costs are aggregated at a portfolio/fund/instrument ISIN level. By this, we mean an aggregation by a single fund, individual share class of a fund (e.g., ISIN) or a client mandate (account). Next, all costs are calculated for a three-year period (PRIIPs) or one-year period (MiFID II). When covering multiple years, costs are averaged across the three years (unweighted) and expressed as a percentage of a portfolio or a fund's NAV. When reporting PRIIPs costs, the cost for portfolio/instrument/account is expressed as a ratio between the three-year average cost and the average NAV of the



portfolio. From a PRIIPs perspective, cost is expressed in portfolio currency and is calculated using either the arrival price or a proxy method, or a combination of both, plus any explicit costs (charges, commissions, taxes and other payments) incurred.

The PRIIPs arrival price methodology uses the time an order is sent from a dealer/trader to the market (broker or venue) to calculate a raw implementation shortfall (the difference between the mid-price at order route time and execution price, side-adjusted). In the first year, not all firms had access to (or had stored) this time stamp (with their account data), so some firms used the time stamp when the order was sent from their order management system (OMS) to their execution management system (EMS) instead, where available.

Furthermore, for auction orders, firms were required to identify orders "initially entered into an auction," which in itself represented a challenge, then to benchmark the execution price of these orders versus the market mid-price immediately prior to the auction.

For FX, some firms adopted the 4 p.m. fix as the benchmark price for all passive FX executions ("initially entered into an auction").

The other PRIIPs methodology uses half-spreads as a proxy for costs. ESMA defined 19 asset classes (Annex VI—Methodology for the calculation of costs) where constituents of an index or a basket of securities could be used in the calculation of a proxy cost.

The spread cost is calculated as the average half-spread cost of all the indexes over a 12-month period multiplied by the portfolio turnover, where the portfolio turnover can be based on an estimation (for new funds) or an actual number (for existing funds). The spread to be used should be that of the close of the 10th business day of each month over a business year.

In practice, actual turnover by PRIIPs asset class tends to be used for funds that have existed for more than a year and for up to three years. Estimated turnover by PRIIPs asset class is used for funds that have existed for up to one year.

As PRIIPs requires up to a three-year average of costs, products in existence for less than three years end up using a blend of arrival price and spread costs, where the spread costs are phased out as the product reaches maturity (crosses the three-year anniversary from inception).

These calculations are notably specific versus those of traditional transaction cost analysis, and the denominator of the ratio calculation (NAV rather than ordered or traded value) is atypical for the calculation of transaction costs. We are aware of several firms that were late to the realization of these differences. These factors, alongside the requirement to ensure integration of time stamps post January 2018 and new PRIIPS "aging into" the arrival price methodology, have created impetus for firms to revisit cost calculations a year into these regulations.

Impact Of Regulation On Investment Firms

Most European investment firms were affected by the EU PRIIPs regulation because they had either direct retail client exposure or were being asked by managers to provide information in support of a (retail) distributor's KID requirements. In addition, ESMA provided guidance in 2018 indicating that costs and charges disclosures under MiFID II (ex-post) should also use the methodology described in the PRIIPs regulation, where applicable.

The last product category in which firms are still exempt from using the PRIIPs methodology is UCITS, at least until 2021. It should be noted that many UCITS were forced into scope for distribution of EPT data and, as a result, calculation of total cost calculations (TCC) as they were used by insurance products.

We believe that, eventually, different product categories will align around a single cost calculation methodology.

A Non-Trivial Effort

The effort required to implement the PRIIPs methodology for transaction costs is not trivial, especially with respect to data requirements.

It is essential that order management systems be able to generate transaction information using the correct time stamp specified in the regulation (route to counterparty/broker), so not all firms had access historically to transaction data with the appropriate level of granularity. This tracking is required for activity post-December 2017.

Of equal importance is the sourcing of intraday quotes and trade data going back three years across a range of asset classes. This can present a significant challenge as well as a significant cost, especially for smaller investment firms. The issue of pricing data transparency and availability for certain financial market products cannot be forgotten. In these cases, it is much more difficult to discover the necessary arrival prices required to implement the PRIIPs methodology.

So, what factors should firms ensure their transaction cost vendor's methodology can accommodate? What questions should firms ask when re-shopping their regulatory trading cost vendor?

- What asset classes are covered? What are the market data sources? What is the waterfall logic when a benchmark (arrival price) is not found?
- What is the coverage rate for the instruments the firm is active in, especially OTCs?
- Can outliers be reviewed and managed? If so, how?
- Are proxy costs available for new products and instruments for which no arrival price is found? Are these proxies consistent with the RTS?

- What results are actually returned to the customer: a final number, or underlying data requiring further calculations?
- Are commissions, taxes and fees handled by the vendor? Or does the client need to manage their effect either in the data feed to the vendor (i.e., include the net effective price in trading data) or in calculations on the returned dataset?

Conclusion

A range of firms are rethinking their transaction cost analysis provider for the purposes of European regulatory reporting. In some cases, these firms are seeking to replace their existing provider with one that is more tailored to their needs. In other cases, firms that were using spread/proxy for their MiFID II costs and charges reporting are migrating to the methodology based on arrival price.

Whatever the rationale, it is essential for firms to ensure they fully understand the methodologies being applied to their data, and that the methodology is consistent with that outlined by the regulatory authorities.

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