THE INVESTMENT ASSOCIATION

Investment Association Response to Call for Evidence: *Transaction Costs Disclosure: Improving Transparency in Workplace Pensions*

4 May 2015

PART ONE: General Comments

1. The Investment Association[1] strongly supports the move to provide improved transparency on both product charges and transaction costs and has already undertaken significant initiatives to help achieve this. These include the Enhanced Disclosure Guidance of 2012 and the Statement of Recommended Practice of 2014, which provide brokerage, transaction tax and spread information for investment funds. More recently, we have published a technical position paper on implicit costs and a recommendation on portfolio turnover rate methodology.

2. The UK debate on transaction costs in the context of pension delivery should be closely linked to two other areas: how product charges are calculated and disclosed through distribution/pensions manufacturing chain; and the emerging EU disclosure requirements for both MiFID-regulated investment managers and product providers subject to the PRIIP KID.

3. In this respect, there needs to be a concerted move both to reach a proportionate, industry-wide settlement on the disclosure of charges and costs for investment and pensions products, and to ensure that this settlement is implemented in tandem and in a way compatible with MiFID and PRIIPs. Specifically, in this context, this means ensuring that the calculation of transaction costs is consistent, even where precise presentation (eg. aggregated vs. granular) will vary.

4. Aggregation, called for under MiFID and PRIIPs, will not in isolation provide meaningful information either about the nature of product charges and transaction costs incurred in delivering investment return. At best, it can provide an indicator of likely economic experience. At worst, it will obscure both charges paid to fund managers and costs incurred within the market. Instead, there should be a clear and consistent manner of expressing charges and costs in the context of both performance and risk taken. Fundamentally, disclosure must retain the objective of helping clients to understand how a manger has delivered against a given investment objective. This will likely necessitate both quantitative metrics and narrative explanation.

5. The question of product charge transparency and net performance for a member becomes particularly important in the context of bundled pension delivery, notably the GPP market that the Novarca template is focused on. Scheme-level value-for-money cost reporting templates will need to examine the effect of both product (administration, communication etc.) and investment management costs on overall return.

6. Our response below focuses particularly on overarching scope, timetable and delivery questions. We believe that the detail will fall into place in the context of the wider delivery framework. Our technical position paper of February already set out a number of fundamental principles, together with recommendations which can serve to inform this

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[1] The Investment Association represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £5 trillion of assets in the UK on behalf of domestic and overseas investors.

framework.

7. What we mean by 'settlement' goes far wider than defined contribution (DC) workplace pensions. It is neither appropriate nor tenable in the context of political and regulatory debates about improved transparency to circumscribe this work. Fundamentally, there is little difference in the nature of the accountability issues being discussed in the DC environment from those that arise in any institutional client market, including defined benefit (DB) schemes. Furthermore, this maximalist view is aligned with the direction of travel in MiFID and PRIIPs.

8. One area, however, that distinguishes DC from DB, and gives DC more in common with the retail market, is that account ownership – and investment risk - in DC schemes ultimately lies with individual members. The debate about appropriate reporting therefore has two distinct levels: the first involving information needed by institutional decision-makers and their advisers, notably trustees, independent governance committees, scheme managers and consultants; the second involving information to end clients. Each level involves both ex ante (forward looking) disclosure and ex post (historic) accountability. For the purposes of the Call for Evidence, we restrict our comments to the first level: ie. decision-makers and their advisers since it is to those parties that information from our members will be disclosed.

9. At delivery level, we propose the following over-arching framework:

   - Alignment to MiFID. The reporting framework should be developed through 2015-16 in coordination with the discussions about the implementation of MiFID II. While MiFID II calls for aggregation of charges and costs, the technical work to establish on what basis transaction costs would be calculated within this aggregation is effectively identical to the UK workplace pension debate about the disclosure of those costs. It is not possible to produce aggregated data without clarity as to the underlying components.

   - Joint implementation group. A joint implementation group, bringing together pension schemes, insurance providers, asset managers and regulators should be set up to devise a standardised framework for reporting across mandate and product types. This would include segregated mandates and all forms of pooled vehicle, notably authorised investment funds and life and pension (L&P) funds. One advantage of such a working group is that it provides the opportunity for a structured dialogue between industry and client groups such that information can be provided in an accessible, practical and, above all, useful form. We would envisage that the chair should lie with an independent, who has both pension scheme and investment management expertise.

   - Reporting framework recognised in regulation. The reporting framework would have regulatory force similar to that currently given to the Pension Fund Disclosure Code (PFDC) under COBS 11.6. The PFDC, agreed originally between the IMA and NAPF, would be revamped to incorporate both changes to dealing commission rules under MiFID and new requirements for transaction cost disclosure. The investment fund mirror of the PFDC (CIS Disclosure Code) would also be revamped and supplemented by a Life and Pensions Disclosure Code, again a mirror of the PFDC.

Addressing timing dislocation

10. The proposed approach will to help address some, although not all, of the timing dislocations that have implications for the implementation of better transaction cost disclosure:

    - New trustee and IGC duties for the consideration and reporting of transaction costs commenced on 6 April 2015 ahead of any clarity from Government and regulators about how disclosure requirements set out in Pensions Act 2014 will be implemented.

    - The timing of the current Call for Evidence and subsequent decisions will leave a gap between the duties commencing and a framework emerging for standardised reporting (should standardisation be the desired direction of travel by Government, regulators and pension schemes). This exposes all parties to different forms of risk as schemes are unsure what to request and investment managers are not yet technically ready to provide information on a systematic basis.

    - Both phases of the UK debate are out of sync with the timetable for MiFID implementation (3 January 2017), which itself has coordination issues: the delegated acts for MiFID are running ahead of the work on the PRIIP KID, a component to facilitate aggregated reporting for distributors under MiFID.

    - At European level, UCITS funds do not fall under the PRIIP KID during a transitional period, subject to review. This leaves uncertainty about the European disclosure framework for a very significant part of the asset management industry. In the UK context, while few DC schemes provide direct exposure to UCITS funds, the latter are frequently wrapped into unit-linked insurance funds for delivery to the scheme and end investors.

11. The use of disclosure codes whose timing is linked to finalisation of MiFID provide the best – if still imperfect – means to navigate UK-EU dislocations. In particular, some of the questions around the scope of the PRIIP KID and extension to UCITS become less problematic if there is a revised CIS Disclosure Code. Furthermore, the 2012 IMA Enhanced Disclosure Guidance on transaction costs already covers the vast majority of UK-domiciled funds in asset terms. This provides information on historic brokerage costs and transaction taxes (three year averages as a proportion of net asset value) as well as better information on spreads and pricing policy.

12. Clearly, this still leaves the problem of the gap between 6 April 2015 and a new framework that might be implemented at the very latest by the beginning of 2017 (MiFID implementation deadline), with the likelihood that the final MiFID parameters will be available by the summer of 2016. Given the clear direction of travel, we would encourage in the interim a pragmatic approach from Government, regulators and pension schemes, together with a 'best efforts' approach from the industry.

Building on existing frameworks

13. In a debate that often implies that there is total opacity surrounding transaction costs, it is

important to emphasise – and build upon – the existing body of disclosure in this area. A significant amount of information is already provided on transaction costs via the existing Disclosure Codes, now supplemented by both the 2012 Enhanced Disclosure Guidance and the new investment fund Statement of Recommended Practice (SORP), which has regulatory force.

14. Accompanying Level 1 (statement of general policies), Level 2 of the 2007 Pension Fund Disclosure Code includes:

- Fund Management fees and any other income derived by the manager.
- Custody costs borne directly by the fund, and to whom paid, if known by the manager.
- Comparative disclosure of trading volumes, commissions generated and how they have been spent.
- Stocklending (if the manager undertakes stocklending on behalf of the client)
- Income to the fund and fees paid.
- Taxes (VAT, stamp duty paid on purchases, any other transaction taxes or levies).

15. In our February 2015 paper, we sought to pull together the various strands of charge and transaction cost information into a single conceptual framework, based on a series of eight principles. We noted that one way to address the challenge of coherent dissemination was to use existing Codes.

Contextualising transaction costs

16. Codes would also provide the opportunity to contextualise cost alongside risk and return metrics, and wider explanation about the way in which a given investment objective or strategy is implemented. We welcome the Novarca report's emphasis on the reality that absolute levels of cost do not tell the full story. The Investment Association's own enhanced disclosure guidance of 2012 provides the text for the quotation on p.26 of the report: "Transaction costs do not necessarily reduce returns. The net impact of dealing is the combination of the effectiveness of the manager's investment decisions in improving returns and the associated costs of investment."

17. In this regard, aggregation under MiFID risks being meaningless as a consistent measure of either product charges or of trading activity within a product. At best, it provides an estimate of economic experience of monies invested. This is an entirely different question to meaningful disclosure of charges and costs. The UK regulatory separation of charges and transaction costs in DC scheme disclosure is both technically correct and in line with findings of the Office of Fair Trading in its DC market report. It is essential for clients to be able to see clearly both what they paying for asset or fund management services, and the transaction costs incurred in delivering those services. Aggregation in isolation will remove that accessibility.

18. Our paper in February spelt out the nature of charges and transaction costs, showing how both could be disclosed in a way that provided both full accountability and good indicators of the overall economic experience of monies invested.

PART TWO: ANSWERS TO CALL FOR EVIDENCE QUESTIONS

Question 1: Should the requirements for standardised, comparable disclosure of transaction costs apply only to those schemes that will be subject to the new governance and charges measures from April 2015? If not, are there differences that should be taken into account when considering transparency in other schemes?

19. As we address in our general comments above, the ultimate aim of the requirements should be that all institutional client groups would eventually be covered by a new generation of disclosure codes that reflect the direction of travel within both the UK and European debates.

Question 2: What are the advantages and disadvantages of capturing and reporting bid-ask spreads? Do you have any views on the ease of identifying bid-ask spreads, or modelling them? What practical challenges are there in calculating bid-ask spreads? Do you have any views on estimation models of bid-ask spreads?

20. The reasons why capturing and reporting bid-ask spreads may be advantageous are set out on page 24 of the Call for Evidence. Paragraph 7 states that the objective of an asset manager should be to maximise return, taking into account the risks and costs of doing so, and Paragraph 8 identifies the following objectives for governance bodies: to assess whether the investment strategy is capable of making up the drag on performance created by transaction costs; and to make a better assessment of the merits of the chosen investment strategy, and potentially, how it is executed.

21. Asset managers should be held to account for the delivery of the objective. The assessment by governance bodies of the returns produced, and whether they have been produced within the established risk parameters is beyond the scope of the Call for Evidence. Nevertheless, the objective to maximise returns does incentivise asset managers to manage and minimise all transaction costs, including bid-ask spreads. Therefore, it would appear to be the role of governance bodies to ensure that they engage and retain asset managers to deliver appropriate and achievable investment strategies and to monitor the asset manager's management of transaction costs, including bid-ask spreads, to ensure value is not lost. Whether or not governance bodies are able to achieve these objectives will depend on the way transaction costs are calculated and presented, and we discuss this further in our answer to question 10.

22. We have shown in previous papers that treating explicit and implicit costs as the same is not appropriate. Brokerage fees and transaction taxes (ie. monies paid) are wholly different in nature to market costs seen in bid-ask spread. Nonetheless, the latter are clearly real costs in terms of creating a drag on return and their nature and significance should be communicated.

23. Depending on the nature of the market and of a particular instrument, bid-ask spreads may be difficult to quantify with accuracy. The Novarca research report itself underlines some of the challenges, making reference to a variety of models and potential data sources. Historically, this has given rise to the emergence of specialist transaction cost analysis approaches to estimate the impact of transaction costs.

24. Despite the challenges, it is already the case that bid-ask spread is routinely estimated, typically on a quarterly basis, for the portfolios of retail investment funds (unit trusts and OEICs) as part of their unit pricing process. Disclosure of the spread was included in the 2012 Enhanced Disclosure Guidance and under the 2014 fund SORP the figure became subject to annual audit. However, it would be wholly inappropriate to claim that implicit costs can be quantified in pounds and pence terms in the same way as broker commission payments made to other parties in the investment chain, or taxes in the case of the Government. It is for this reason that the Dutch Federation of Pension Funds transparency framework uses industry-agreed estimates as a starting point. This could be an initial model for the UK.

25. Given the scope of MiFID, we would note that MiFID-regulated brokers as well as MiFID asset managers will be required to improve the level of transaction cost reporting. This will help to achieve improvements in reporting to managers, as well as by managers which will ensure that the quality of information is enhanced over time.

Question 3: What are the advantages and disadvantages of capturing and reporting market impact? Do you have any views on the ease of identifying market impact costs? What practical challenges are there in calculating market impact costs? Do you have any views on the possible estimation models of market impact? Do you have any views on the availability of these models, their consistency, and the costs providers charge to access them?

26. We do not believe that this level of granularity is appropriate for standardised disclosure material. However, in terms of detailed reporting analysis, the potential advantages are, in principle, the same as for bid-ask spreads discussed under Q2. An indication of market impact as trade size increases relative to the market might help governance bodies assess whether a particular investment strategy is appropriate for the size of the scheme in question. It might also help governance bodies to assess how well the asset manager executes investment decisions on behalf of the scheme.

27. However, it is important not to forget that the size of a trade is a relative measure dependent on the abundance of other buyers or sellers in the market at any given time. The levels of market liquidity provided, and market volatility caused by other buyers and sellers is entirely out of the control of the asset manager. As a function of market liquidity and market volatility, market impact is more naturally regarded as a function of underlying market risk. Asset managers can mitigate the market impact risk through their trading strategies but cannot control the abundance of other market participants. Therefore, market impact should be carefully understood before it is determined whether it should be disclosed as if it were a cost over which the asset manager can exert control.

28. We have made clear in our technical paper of February 2015 that there are different questions relating to implicit cost: those relating broadly to the characteristics of a market in which trading is taking place, and the question of 'how well has a trade or trades been executed?' Both should be examined, but it is not clear to us that the latter is appropriate for standardised disclosure documentation.

29. In terms of calculating and reporting, the Novarca report neatly illustrates some of the challenges here: it points out that predictive models may be used which are very accurate,

but this is not the same as post-trade quantification. Indeed, the point seems to be that it is "consensus estimates and market averages" that can initially provide information that will be of value in promoting transparency in this area (p.17).

Question 4: Do you believe that missed trade "opportunity costs" and "delay costs" are transaction costs? Do you believe that there is merit in reporting them as part of the disclosure regime and in governance bodies reviewing them? Do you believe that the practical issues, for example around the subjective nature of some of the inputs needed to calculate them could be addressed?

30. As we note above, questions as to how effectively trading has taken place in a given market are in a different category to those looking at the costs of trading in that market. This area is not appropriate for a standardised disclosure framework. Fundamentally, the definition of transaction costs relates to transactions that have occurred and not to the economic cost of transactions that did not happen (opportunity costs).

Question 5: Do you have any further thoughts on the analysis of transaction costs outlined in this chapter? Are there any alternative approaches to identifying transaction costs, or other considerations to take into account?

31. The fundamental connection between risk, return and cost needs to sit at the heart of the transaction cost discussion with trustees and IGCs. Transaction costs within a market and/or portfolio may be explicit, implicit, high or low. Ultimately, what matters is the level of return generated subject to risk taken. A high turnover strategy may be significantly value-enhancing for a client, or it may not be. The judgement of that will not depend on simply looking at how high or low transaction costs have been.

32. Any standardized framework needs to take this into consideration and the Novarca framework recognises this by including risk and return as part of the core template. However, we would see these figures as being so fundamental as to appear on the first page of the asset manager's report to the governance body with the cost analysis being a support schedule. Beyond this, there lies the higher level of analysis as to the efficiency of trading, which starts to enter into areas of best execution obligations and how compliance in this area can be demonstrated.

Question 6: Do you have any comments about the different frameworks within which information might be reported and their respective strengths and weaknesses?

33. The narrative preceding this question in the Call for Evidence highlights the difficulties in designing a framework. Paragraph 3 highlights the usefulness of the information as an important consideration and acknowledges that the costs of producing it should be in proportion to its usefulness.

34. The ensuing paragraphs identify that more granular information might be most useful, enabling governance bodies to hold each asset manager to account for the costs in each of the portfolios being managed. However, the desire to reduce complexity (which appears to mean the length of the report) is also explored and it is suggested that some form of aggregation would reduce the burden. We agree with the comments in paragraph 9 that too much aggregation would result in governance bodies being misled about the true

origins and nature of transaction costs.

35. With respect to practicalities of reporting, we would observe that transaction costs arise at portfolio level when the investments underpinning a scheme are actually traded in the relevant markets. Capturing transaction costs therefore necessarily takes place at the most granular level with subsequent reporting along the investment chain. If any attempt is to be made to capture actual costs, the reporting burden and system cost is likely to be similar regardless of whether the figures are subsequently aggregated. Whether or not an analysis of actual transaction costs is sufficiently useful to justify the burden is discussed in our answer to question 10.

36. Usefulness also relates to how figures are presented. The concept of a "unit transaction cost" is introduced in paragraph 70. We consider this well put since it tackles both predictable and unpredictable aspects of transaction costs. We identify and analyse this issue in our technical position paper (see in particular Appendix 4), which shows that expressing transaction costs relative to transaction value can provide a useful general indicator of dealing efficiency.

37. Ultimately, disclosure frameworks are only as strong as their ability to provide users with relevant and consistent information. Having heard a wide variety of views from client and adviser groups about how transaction cost data is likely to be used and evaluated, we would suggest that it is for them to be the best judge of respective strengths and weaknesses.

Question 7: How should transaction costs incurred at product level be captured and reported? Would there be merit in splitting out costs incurred for different reasons? How could this be achieved in practice? Are there any other costs incurred at a product level that are not administration charges, and that could potentially be considered transaction costs?

38. One of the major challenges in transaction cost reporting at product level is that it becomes much more complicated once you move beyond specialist (ie. single asset) portfolios. Disclosing and comparing transaction costs in a multi-asset portfolio is arguably a wholly different exercise to comparing transaction costs or turnover levels in a UK equity portfolio, for example. However, the underlying issue is exactly the same: how to judge cost in the context of risk taken and return delivered.

39. The proposed Novarca approach uses an asset-based portfolio template at scheme level. This implies that schemes using, for example, several multi-asset funds within a default strategy would have to request asset-level reporting and then re-aggregate. A legitimate question then becomes what the aggregated reporting is really revealing about cost, risk or return where the judgement necessarily needs to lie at underlying fund level.

40. A further issue in terms of scheme level reporting arises with respect to costs that have no connection to investment delivery but impact overall member return (eg. GPP administration charges wrapped into a fund unit price). Any value for money judgement will necessarily have to consider these different components of cost. The investment return delivered for a given level of risk and transaction activity cannot be effectively assessed unless this is taken into account.

Question 8: Do you have any views on whether pension schemes should be required to look through to the transaction costs of all listed, exchange-traded investment schemes? Do you have any particular comments on how the transaction costs incurred by property, (and other real asset investments), private equity and hedge funds should be identified and disclosed? Is separate guidance needed on how to disclose transaction costs in these areas, or can the principles used in securities markets be applied?

41. This is an area of significant challenge that does not simply affect transaction costs, but also product charges. One question that has already arisen in the context of the charge cap is how to treat investment trusts that are simultaneously listed securities and professionally-managed vehicles used for the delivery of specific investment objectives in the long-term savings and pensions market. On both product charges and transaction costs, the need for consistency would suggest that look through should apply, whether it is an underlying investment fund or an investment trust. However, we recognise that listed securities represent a potential anomaly.

42. Property and other real asset investments present further difficulties. Buying and selling real assets involves bespoke transactions and in the case of property, transaction taxes are an order of magnitude higher than for securities. Moreover, real assets incur a type of asset-related costs that are, in nature, neither scheme and investment administration expenses nor transaction costs (examples include rent collection, buildings insurance, utility costs, building services, ground rent, valuation costs). Separate guidance on the treatment of such costs in relation to the charge cap and transaction cost disclosure is vital in order to avoid denying default arrangements the benefits of investing in real asset classes.

Question 9: Do you have any comments on the treatment of derivatives? Should the costs of derivatives be disclosed separately somewhere within the disclosure reports? Do you have any comment about the transaction costs associated with structured products?

43. Yes, the cost of derivatives should be disclosed. This will be addressed under both MiFID and PRIIPs, with structured products providing a particular challenge for the PRIIP KID technical process.

Question 10: Do have any views on the different approaches to calculating transaction costs? Do you agree that a principles-based approach is appropriate to set how transaction costs should be reported for each type of asset? Do you have any comments on the reporting of negative transaction costs?

44. The question about the different approaches used to calculate transaction costs should be answered in the context of what information is useful to governance bodies in order to enable them to discharge their obligations in this respect. Paragraph 20 of this response analyses governance bodies' objectives as set out in the Call for Evidence: these are to assess whether the investment strategy is capable of making up the drag on performance created by transaction costs; and to make a better assessment of the merits of the chosen investment strategy, and potentially, how it is executed. This would appear to include both a forward-looking assessment of investment strategies and a backward-looking account of the costs of executing a chosen strategy.

45. On a forward-looking basis it is necessary to consider whether the strategy is likely to

overcome the costs of implementation by the desired margin, so it would be useful to be aware of indicative unit costs for the relevant markets – such as the spreads, commissions and transfer taxes for buying and selling the relevant instruments. For this purpose it may be sufficient to rely on standardised rates for particular markets.

46. On a backward looking basis, there is a difference between broad accountability for overall transaction costs incurred and the question of considering whether the strategy was implemented efficiently. Here, it is the actual unit cost that provides the most useful information, and allows meaningful comparisons with peers or benchmarks. It may mean little to compare transaction costs of two schemes in monetary terms (is a scheme with £1,000,000 of transaction costs better or worse value than one with £2,000,000?) or even to express these in terms of the overall scheme value (is a scheme with 0.4% of transaction costs better or worse value than one with 0.5%?). Knowing that a scheme has incurred 0.1% of commission on average when dealing in UK equities compared to a benchmark of 0.07% may be more useful; in this example it is evident that commission rates could be improved.

47. This example draws attention to a potential limitation of the Dutch framework, which uses standardised assumptions about market spread and applies them to volume traded to estimate total costs incurred. This will not facilitate that kind of efficiency observations described in the preceding paragraph.

48. With respect to the use of principles-based or more prescriptive approaches, much will depend upon the asset class and the nature of the transaction cost. Where quantification is straightforward (eg. brokerage fees explicitly paid), the approach will not be the same as markets in which there are no explicit costs and/or low liquidity of a given instrument(s).

Question 11: Should portfolio turnover rates be reported alongside transaction costs? If so, do you have any comments on the best methodology to use to ensure comparability of portfolio turnover and transaction costs?

49. Portfolio turnover rates (PTR) belong alongside transaction costs insofar as the latter are also reporting alongside risk and return. In other words, consideration should be given to a range of metrics in assessing performance. We have done extensive work on PTR and our specific recommendation can be found in our technical paper of February 2015, based on a modification of the SEC approach.

Question 12: Do governance bodies need risk and return information to be reported alongside transaction costs, or is it sufficiently readily available to them from other sources, considering the balance of costs and benefits that such new requirements may impose? If you think risk information should be reported, do you have any feedback on the best risk measures to use when considering transaction costs?

50. While it is for governance bodies to determine precisely what they need, we would suggest that it is appropriate to bring together this information in one place: ie. presenting transaction costs (or charge information) alongside other information regarding risk, return and investment strategy.

Question 13: Do you have any views on the value and/or costs of benchmarking? Are there any other issues to be taken into account when exploring benchmarking?

51. Benchmarking can help to provide meaningful information, as opposed to simply providing accountability and transparency. While the latter objectives are important, so too are questions about the quality of trading and/or the behaviour of some managers relative to others. However, benchmarking is only useful if there is a high level of accuracy in actual reported costs. Benchmarking schemes using standardised industry wide assumptions against the averages that underpin those very assumptions will serve no purpose.

52. However, there is an important point to emphasise here. A client that is dissatisfied with the overall performance of their fund manager(s) can choose to change the manager. This will usually result from a period of under-delivery relative to expected objectives. A client that is dissatisfied with the trading efficiency of the fund manager cannot keep the investment decisions, but swap the dealing teams and achieve a better overall return. Benchmarking and analysis of transaction costs will therefore inform a conversation that might be one factor in the ongoing relationship, but it is most unlikely to be a determining factor in any decision to fire (or hire).

Question 14: Do you have any feedback on the reporting of the costs of securities lending, foreign exchange and related activities, and on how these should be reported? Are there any other areas or practices that you would highlight where providers are imposing additional costs or generating "hidden" revenues?

53. It is essential that the reporting of costs is contextualised appropriately. We agree that there should be full transparency about the destination of all revenues earned from stock-lending, but the economics of such arrangements are more complex. To properly understand the arrangements requires disclosure of the total revenue generated and the proportion paid to the scheme and to all other parties that benefit from some of the revenue. It also requires disclosure of the amount and nature of the collateral held by the fund to mitigate against the risk of default by the borrower and of the terms for recalling the loaned stock. Isolating a part of the picture in a costs disclosure report heightens the risk that the costs are not assessed in the appropriate context.

54. We agree that foreign exchange costs should be transparent and the rates achieved in relation to standard custodial services such as cash sweeps, contractual settlement arrangements and processing of dividends received from overseas investments.

Question 15: Do you have any comments on the practical issues with presenting costs and charges information? Do you have any comments on the degree of standardisation that will both enable governance bodies to take decisions on their scheme and achieve comparability across the market? Are there any other factors in the presentation of transaction costs in a report that would enable governance bodies to make better decisions?

55. The obvious practical issues hinge on the distinction between accountability and meaningful judgement of performance. We already pointed out above that breaking out individual asset class transaction costs within a multi-asset portfolio to recombine them in an asset-class reporting framework for value-for-money will achieve one thing only: accountability in terms of overall cost. As for value-for-money, this will be seen in the

context of what the manager was trying to achieve: for example, what would be the value put on tactical asset allocation that resulted in transition costs but raised the overall return on the fund?

56. Other similar such issues will arise. Ultimately, it is unlikely that pension scheme investment decisions will be taken on the basis of transaction costs in isolation. They will be taken on the basis of understanding investment objectives, investment processes, charges and risk. Transaction costs are not front and centre of institutional decision-making criteria internationally. This is not to diminish their significance, or the significance of this exercise. However, it is to emphasise the need for proportionality in a debate about costs necessary to deliver a return for an investor.

Question 16: Do you agree with the use of portfolio turnover rates and unit transaction costs to enable better prediction of likely transaction costs? Should providers be required to provide reasons if turnover rates are likely to be different in the forthcoming period? Is there any other information that would enable the governance body or scheme members to understand potential future transaction costs?

57. There is a regulatory consistency point arising here. If past performance is ruled as being no guide to future returns, then neither can transaction costs be presented as having a predictive quality. That said, we would add some caveats:

- Just as past performance gives an account of manager strategy, historic transaction costs (perhaps averaged over three years as suggested by the Investment Association Enhanced Disclosure Guidance) can give a useful indicator. It will be apparent, for example, that there is a significant difference between an index tracker in a given market and a highly active trading strategy.

- Some strategies are and remain based on high turnover. Therefore PTR metrics may well provide a useful indication of approach, subject to caveats about what they imply about the relationship between risk, cost and return.

Question 17: Do you have any comments on whether a transaction cost disclosure regime will have any other consequences for the way that pension schemes and their agents transact?

58. It is possible that clients and managers will have more detailed conversations about the nature of the investment process and the markets in which they invest. However, we would emphasise two points. First, asset managers do not have incentives to hide transaction costs, since measurement against risk taken and return generated is the ultimate way by which performance is judged. Second, it is our understanding that the Pension Fund Disclosure Code rarely results in dialogue with clients, and is often seen by asset managers as a one way process of accountability for investment services delivered.

Question 18: Should regulations and rules on transaction cost disclosure only directly apply to pension providers and trustees? If not, on whom would additional disclosure requirements be necessary to ensure that transaction costs are reported accurately to relevant people?

59. There should be clear requirements on industry to provide such information, framed in the way suggested in our earlier comments (ie. the regulatory status of the proposed Codes would bring asset managers under a responsibility to disclose). This is a protection for clients, but also helps to provide consistent and clear guidance for firms themselves.

60. We would emphasise that in any case stringent disclosure requirements are extending to asset managers under MiFID and PRIIPs. This will effectively provide the top level regulatory requirement, but the approach proposed in the UK pensions environment should result in much more useful information given the disaggregation required.

Question 19: What information on transaction costs would be useful to employers and members? How and when should this be reported to them?

61. We would recommend that this question is addressed in detail once UK trustees and IGCs are comfortable with the disclosure regime to them. A more considered view may then be taken about how best to disclose, and consumer testing can be undertaken to inform any decision. At EU level, retail clients will receive the PRIIP KID (subject to the delay applying to UCITS). The consumer testing of the KID may throw up some useful insights in this area.

62. We continue to believe that any aggregated charges and cost information should be accompanied by a disaggregation of product charge and transaction cost. Otherwise, an indicator of economic experience will replace an indicator of commercial payment for service. This can hardly serve consumer transparency.

Question 20: What information on costs and charges should be made publicly available? When and how should this be information be provided?

63. It is already the case that both charge and transaction cost information for investment funds is available, although transaction costs are not currently included in point-of-sale literature. Given the European regulatory intent to aggregate charges and costs in such literature, we would wish to see an element of granularity so that both fund management charges and transaction costs are clearly visible. We would expect that this approach be used across substitutable investment products. With respect to historic reporting, we would expect that our proposed Disclosure Codes would be available. However, this question also raises the issue discussed earlier of how to contextualize this information.

Question 21: Are there any areas that you would highlight where firms, trustees or asset managers may not comply with the disclosure regime in the way intended? If you are concerned that this may be the case, are there steps that could be taken to reduce the incentive to get around reporting transaction costs? Would third-party oversight of reports enhance their value and usefulness?

64. It is not clear why asset managers would have an incentive not to comply with the disclosure regime in the way intended. Providing accountability for a return already

delivered does not change the fundamental judgement by a client: how effective was the manager in delivering the return for a given level of risk.

Question 22: Do you have any comment on the likely costs involved in implementing transaction cost disclosure along the lines described in this call for evidence?

65. System build costs are inevitable, but the industry recognises the need to provide greater levels of transparency. A critical priority for The Investment Association and its members is to ensure one build to address both forthcoming UK and EU regulatory requirements. The danger of not joining up the UK pensions debate with the EU debate is that both industry – and its clients – have to navigate fragmented and inconsistent reporting mechanisms. This is in nobody's interest.