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By email: cp16-30@fca.org.uk

Date: 4 January 2017

Dear Michael

RE: CP16/30: Transaction cost disclosure in workplace pensions

The Investment Association is delighted to provide input to your consultation.

We attach below our detailed response to CP16/30. As you know, The Investment Association strongly supports the need to provide accessible, comparable and consistent information on product charges and transaction costs across the markets served by its members. It is for that reason that we are developing a new Disclosure Code intended both to facilitate the intent behind CP16/30 and extend the coverage more broadly to allow all client groups access to enhanced information.

We also support in principle the need to ensure that there is maximum consistency between UK and EU disclosure regulation, and between different parts of the EU regulatory framework. This will help avoid the provision of information that is subject to significant degrees of variation and potentially therefore serves to confuse. Such consistency is also clearly in the interests of industry, both in terms of ensuring cost-effective and non-duplicative systems build, and in ensuring that client communications can be undertaken in a joined up manner across and between different jurisdictions and product groups.

However, as we have communicated to both the FCA and European regulators over the past 18 months, we are extremely concerned about the proposed methodologies for the calculation and disclosure of implicit costs. As the FCA and other regulators acknowledge, this is an exceptionally difficult area, not because of practices within the asset management industry, but because of the nature of markets in which firms invest on behalf of their clients.

We believe that the slippage approach proposed in both PRIIPs and CP16/30 is profoundly flawed. First, it borrows from equity trading an approach that is used primarily to measure quality of trading in a given stock or security, not the loss of value (ie. economic cost) arising from the existence of a bid-offer spread. This can give rise to apparently counter-intuitive results, such as negative costs, which may lead to the erroneous conclusion that trading in a given market carries no costs. Second, it is not clear how trustees and independent governance committees should interpret such information, particularly with respect to value for money responsibilities. Third, it depends on data that is currently

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difficult to source with accuracy outside the most liquid trading environments. While MiFID II may help to address some of this, the outcome will not be apparent for some time.



The Investment Association, among others, has proposed instead a pragmatic alternative that will allow the emergence of estimates to satisfy the regulatory expectation of quantification of loss of value. This would focus on a spread estimate, which is already used. Over time, as wider data availability evolves, particularly in the context of MiFID II, this approach could be revisited using an evidence-based approach. We would note that neither the FCA nor the European regulatory authorities have published evidence across different asset classes as to how the proposed methodology would operate, including in comparison to alternative approaches such as spread. In the absence of such evidence, and given evidence from the industry about the potential for counter-intuitive results, we would urge the FCA to reconsider.

We would be very happy to discuss in more detail with you any aspect of this response if that would be helpful.

Yours sincerely

Mark Sherwin

Senior Adviser, Financial Reporting

ANNEX I

CONSULTATION RESPONSE

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association is the trade body that represents UK investment managers, whose 200 members collectively manage over £5.5 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

The UK is the second largest investment management centre in the world and manages 37% of European assets.

More information can be viewed on our [website](#).

Q1: Do you agree that our proposed rules will enable information on transaction costs to reach governance bodies? If not, what alternative(s) would you propose?

Yes, we agree with the proposed approach whereby the obligation to provide information arises in response to a request for information and that the obligation should relate only to a request from an adjoining link in the arrangement – investment vehicle – underlying fund chain. We think that the proposal will enable information to reach governance bodies.

We agree that entry, exit and switching costs are specific to individual members and should not be aggregated with other transaction costs. This principle should apply along the investment chain such that where an arrangement invests in an underlying fund it is the duty of the arrangement, not the underlying fund, to identify and disclose the entry, exit and switching costs incurred by the arrangement.

However, we do not agree that typical swing prices should be regarded as a form of entry or exit cost, as is suggested at the end of paragraph 2.8, for the reasons set out in our answer to question four.

Q2: Do you agree with the approach set out for calculating transaction costs? If not, what alternative(s) would you propose?

No, we disagree strongly with the proposed methodology for calculating implicit costs. There are three fundamental interconnected problems with it:



- 1. Nature of what is being measured.** As set out in paragraph 3.6, there is a loss of value when one asset is exchanged for another and this loss of value can be regarded as the cost of a transaction. In a purchase transaction for UK equities, cash is given up to pay the asking price, commission and stamp duty. In exchange the buyer receives shares that are valued at fair value in accordance with accounting standards. We advocated recognising this loss of value as a cost in our 2015 position paper¹.

However, having articulated this approach, the FCA have actually proposed something different. Instead of comparing the actual cash expended (or received for a sale) to the fair value of the investment at the time of the transaction, the proposal makes a comparison to the fair value at a different time; the arrival time.

The flaw inherent in this time shift is that, whilst attempting to capture the impact of an order to trade on the market price, the approach also captures the impact of all the other market participants and the fact that the market for a particular share is influenced by the sentiment of the wider market; a factor known as market trend. The result of this flaw is that the costs captured represent factors that are entirely unrelated to the transaction in question. Paragraph 3.28 expresses the view that these unrelated factors should tend towards zero. However, managers are now starting to back test the methodology in the PRIIPs context and emerging evidence shows that the slippage cost methodology is prone to produce abnormal results that misrepresent the actual cost of trading.

These abnormalities are not surprising given the nature of the methodology, which was developed not to measure in accounting terms the loss of value occurring in a transaction, but the effectiveness of the trading processes. In other words, we believe there is a risk of a category error in this consultation paper. By proposing a tool whose main purpose has been to analyse the quality of trading and not a quantitative conclusion regarding transfer of value, there is a risk of an 'apple and pears' comparison between different components of cost within the investment process.

- 2. Consistency and accessibility.** This fundamental issue of definition risks diminishing the ability of governance bodies to reach a meaningful interpretation of costs as they attempt to compare across different schemes to form a view on whether scheme members are receiving value for money. In place of the slippage cost we recommend using spread as the most reliable measure of implicit costs (which would not prevent governance bodies having a separate conversation with managers about trading quality captured in our remarks above).

Governance bodies are expected to compare transaction costs with other schemes and to take action to address areas of poor value. There is a significant risk that a manager challenged by a governance body to reduce transaction costs if they want to keep the business will be incentivised to shift their focus towards reducing slippage costs instead of improving execution outcomes.

- 3. Data availability.** We agree that the slippage cost is a simple calculation. However, sourcing the data required to run the calculation is not straight forward. Whilst the execution price relates to the trade in question the arrival price is market data. In this context a market takes the form of an exchange or a trading platform where market participants gather (physically or electronically) in order to trade with each other. Typically markets are demand driven and provide constant tradable quotes that are readily accessible. This is market data.

¹ Investment Association, [Meaningful disclosure of costs and charges: Position Paper](#), February 2015.

In contrast over-the-counter 'markets' for trading bonds and derivatives are not markets in this sense; trading takes place on a bilateral basis by negotiation. Trading is often supply driven and quotes are often indicative in nature. There is no market data. Instead data vendors synthesize bond valuations based on analytical techniques and these valuations underpin the calculations of funds' net asset values.



EVIDENCE ON NEW METHODOLOGY

We heard from fund managers that have calculated transaction costs in accordance with the PRIIPs RTS over a period of three years. The results from four firms below show that a significant proportion of the funds would report highly inconsistent figures, as follows:

1. A range with about 270 funds showed transaction costs in the range between -7.9% and +6.6%. In this range 18% of funds have negative transaction costs, 40% have transaction costs greater than 1%² and 13% are above 3%. Only 42% of funds have transaction costs in the range between 0% and 1%. With about a third of these funds showing abnormal transaction costs (negative or greater than 3%), the validity of the methodology is highly doubtful. These results suggest that even where the results appear plausible, the proportion of abnormal results casts doubt on all the results.
2. Another range with about 130 funds showed transaction costs in the range between -1.75% and +3.65%. In this range 30% of funds have negative transaction costs and 13% have transaction costs greater than 1%. Only 57% of funds have transaction costs in the range between 0% and 1%.
3. A third range of seven funds showed transaction costs in the range between +0.5% and +7.7%. In this range 6 funds (86%) have transaction costs greater than 1% and 3 funds (43%) are above 3%.
4. A fourth fund manager has a fund with transaction costs of -0.86%.

These figures are based on the interim provisions in the PRIIPs RTS whereby in the first three years managers can use opening, or previous closing, prices as a proxy for the price at the arrival time. Therefore it is easy, and no doubt tempting, to dismiss these outcomes as merely being a result of the PRIIPs interim provisions which are not available under the FCA's proposed approach. However, we have also heard from a fund manager that has calculated transaction costs by sourcing intra-day prices at the actual arrival times over a three year period.

5. This manager has tested five equity funds using actual arrival prices sourced from a TCA provider. In four of the funds the implicit costs were nil or negative. In two cases where the implicit costs were negative, this offset almost completely masked the existence of explicit costs and in one case it gave a material negative outcome.

Fund	Implicit	Explicit	Total
UK equity A	-0.25%	0.30%	0.06%
UK equity B	-0.22%	0.25%	0.03%
UK equity C	-0.60%	0.12%	-0.48%
UK equity D	0.00%	0.16%	0.16%
Global equity	0.34%	0.14%	0.49%

These results suggest that even where transaction costs figures appear plausible, the proportion of abnormal results casts serious doubt on all the results.

² Based on our members disclosures of portfolio transaction costs including spread in accordance with our 2012 guidance, total transaction costs can be expected to exceed 1% in only a very few cases.



Our alternative proposal is to use spread as the measure of implicit costs, applying half the spread to the total purchases and half the spread to total sales. We note that the FCA found that this would be likely to pose significant challenges and explain what these are on page 15. However, we think that these challenges are just as significant when attempting to measure slippage costs by reference to an arrival price that is defined as the mid-market price (ie. the mid-point of the spread) at a point in time. Moreover, managers already identify spread as an integral part of their unit pricing systems and dealing decisions and, in the case of UK authorised funds, report spread as part of the audited financial statements. Spread may not be strictly accurate in relation to every individual trade, but over a year its inaccuracies are more likely to tend towards zero than is the case with the slippage approach.

IMPLEMENTATION TIMEFRAME AND TRANSITIONAL ARRANGEMENTS

If the FCA does persist with the slippage methodology we recommend considering carefully the implementation timeframe and transitional arrangements. Our evidence above suggests the most extreme results arise when opening or closing prices are used as a proxy for the arrival price in the PRIIPs RTS transitional period. At the same time the FCA needs to give the industry sufficient time to develop the capability to source and store arrival prices ready for the start of the first period for which they will be needed.

Therefore we would propose that in the first year of implementation there should be a transitional arrangement whereby the spread methodology is used. This would appear consistent with the FCA's assertion in paragraph 3.25 that the slippage cost is close to a calculation of effective spread and would expedite implementation in the latter part of 2017 with the slippage cost methodology coming on stream a year later.

In addition we would encourage the FCA to commit to a formal review of the slippage approach by the end of 2018 in line with the ESA's timeframe for reviewing the PRIIPs RTS methodology.

Q3: Do you agree with the proposals in this chapter? If not, what alternative(s) would you propose?

This question deals with issues arising from the application of the slippage methodology to specific asset classes and our answers here follow from the general views expressed in question two. The specific issues would not arise if our preferred option of using spread were adopted.

At worst we are concerned that, contrary to the view expressed in paragraph 4.2, the approach will create incentives for asset managers to behave in a particular way such as seeking to time transactions to manage the outcome in the context of transaction cost disclosure, rather than building towards a meaningful consideration of loss of value. This could have some dangerous ramifications affecting both active and indexing funds.

We understand that passive index-tracking funds routinely place orders throughout the day in response to investor flows for execution at close, or another fixed time, in order to most closely replicate the index. The execution prices, and therefore the performance outcome, will track the index. However, the slippage cost will capture the market movements between order and execution. The result will be significant costs being disclosed that are unrelated to the strategy being followed; the costs disclosed would not account for the difference between the index return and the fund return.

In order to mitigate this issue there is a risk that passive managers delay releasing their orders until close to their target execution time so as to reduce the capture of market movement as cost. In principle this would have no impact on execution so would not affect

performance outcomes. However, if multiple passive managers take this same approach there would be significant consequences for order flow making it harder for the sell side to supply liquidity and potentially having an adverse effect for the buy side on the prices achieved. The result would be heightened operational risk, lower disclosed costs and lower net performance.



If the FCA persists with the slippage methodology we think it would be more appropriate to target an arrival time at, or as close as possible to, the actual or specified execution time.

OTC VS. EXCHANGE-TRADED INSTRUMENTS

As we note in our answer to question two, the FCA's general approach is to use transaction cost analysis techniques developed by participants in equity markets for the purpose of evaluating how efficiently they can implement investment decisions and how effective their dealing desks are. This is a highly technical area that is still searching for the homogeneity necessary to facilitate comparisons between firms. Therefore the methodology will be problematic even in the equity space. Equity markets are formal exchanges that are characterised by high levels of continuous trading activity, a continuous supply of committed price quotes, a large number of market participants and a continuous output of publicly available price information. As such it is possible to benchmark the price of a trade against the market price at a point in time to reveal an indication of the implicit cost.

However, taking the technique off-exchange and attempting to apply it to over-the-counter (OTC) transactions such as bonds, derivatives and property ignores the fundamental differences in the infrastructure for trading. OTC transactions typically take place on an infrequent bilateral basis and where prices are publicly available it is often not possible to determine their age or quality. Moreover there may be only one or a very few brokers prepared to make a market in a particular bond issue. International accounting standards (IFRS 13) make a fundamental distinction between the levels of reliability of prices for determining fair value; binding quoted prices from exchanges are able to be disclosed as top tier valuation measures whilst the prices of bonds must be disclosed in a lower tier in order to indicate that they are significantly less reliable.

In the case of bonds the FCA's approach seems to be to permit the use of daily closing prices from data vendors as a fair approximation of an arrival price. We are aware that the FCA has access to details of a significant number of corporate bond transactions in the Zen system that could be used to test whether this approach is reasonable. We understand that volume, typically generated by open-ended fund flows, and volatility are highly correlated. Therefore it may be that a high proportion of the number of trades take place in benign conditions, but a large portion of the volume traded happens in a smaller number of trades in volatile conditions. It would be helpful if the FCA published the results of any testing that may have been done in this respect.

Our evidence in our answer to question two demonstrates that there will a significant number of occurrences of abnormal transaction cost figures, both positive and negative, that will lead to confusing and potential misleading disclosures. In the extreme we have seen figures for individual fixed income funds in the fund ranges discussed in our answer to question two with transaction costs as varied as -7.9%, +2.5%, +1.1% and 0.2%.

OTC derivatives are typically bespoke bilateral contracts with no price transparency. They fall into the lowest of the three tiers of reliability in international accounting standards which is reserved for instruments with no observable pricing data. Here the FCA's approach is to approximate the arrival price using a weighted average of the derivative's underlying assets. It remains unclear what the FCA expects where there is no underlying assets; swaps are the most commonly used derivative in pension funds and these reference factors such as interest and inflation rates rather than assets. We think the distinction between the

approaches applicable to linear and non-linear derivatives in 19.8.12 G (2) and (3) is too inflexible and should be deleted.



Applying the approach to property seems akin to asking an estate agent to value your home, putting it on the market, comparing the eventual sale price to the estate agent's valuation then calling the difference a cost. There is nothing you can do to manage this cost or to change the outcome apart from holding out in the hope of a better offer from another buyer. This analysis tells you nothing about cost, only that estate agents might have a tendency to value optimistically.

Q4: Do you agree that our proposed rules will enable pension arrangements and funds that invest in other funds to amalgamate the total transaction costs from underlying funds?

Yes, we agree. To the extent the manager is subject to FCA rules, the proposed rules place an obligation on the manager of an underlying fund to respond to a request by disclosing an aggregation and breakdown of transaction costs. This facilitates amalgamation of the disclosed costs by each adjoining link in the investment chain. In this respect we reiterate our view set out in our answer to question one that the principle set out in paragraph 2.8 should apply along the investment chain such that where an arrangement invests in an underlying fund it is the duty of the arrangement, not the underlying fund, to identify and disclose the entry, exit and switching costs incurred by the arrangement.

However, we do not agree that an anti-dilution levy, or the equivalent price adjustment in swinging pricing and dual pricing systems, represents a transaction cost as is asserted in paragraph 5.3. Prices may be swung to protect funds from dilution caused by money flowing in or out being invested in underlying assets. If scheme members were to buy the underlying investments for themselves they would necessarily pay the asking price plus transaction costs. They are in the same position if they place their money into a pooled fund that has swung its price up in response to net inflows. If the pooled fund has not swung the price, or has swung the price down in response to net outflows, then the scheme member receives a benefit by being able to gain exposure to the underlying assets at a lower and more favourable price than they otherwise could have achieved. The scheme member is never worse off, and may be better off, as a result of using a pooled fund. Therefore, it is not appropriate to disclose the potential benefit as if it was a cost.

Moreover, to disclose the price swing as a cost is inconsistent with the slippage cost principle set out in chapter 3. The principle measures cost by comparing the transaction price to a benchmark price, the latter being the mid of the buying and selling prices for a particular asset. In effect, the cost is the loss that would arise if the asset was bought and sold simultaneously. However, transactions by buyers and sellers of a pooled fund all take place at the same single swung price; there would be no loss for a simultaneous buy and sell so it is not appropriate to disclose a cost. Therefore, we think that proposed rule 19.8.10 R (2) should be deleted.

Q5: Do you agree that transaction costs should be amalgamated on the assumption that underlying funds incur them evenly over a reporting period? If not, what alternative solution(s) would you propose?

Yes, we agree that schemes need to make this assumption in order to collect and use cost information without incurring disproportionate costs in doing so. To do otherwise would create a very different cost benefit analysis.

The FCA's CBA is based on the fact that eliminating ad hoc requests will save firms £8.3m per annum. If firms were to be expected to calculate and disclose costs by reference to each scheme's accounting period, instead of the accounting period of the pooled fund in question, this benefit would not be realised and the FCA's CBA would be invalidated. The benefit of standardisation relies on managers calculating transaction costs once for each pooled fund and then disclosing the same figures to all their clients, regardless of those clients' own reporting periods. Standardising the period of account to be that of the pooled fund is far more significant than standardising the calculation methodology, although we discuss the latter further in our answer to question seven.



In this respect we find the guidance proposed at 19.8.6 G (3) is clear in the context of the commentary in chapter 5, but once the proposals are required to stand alone in the Handbook without that commentary we think there is potentially some ambiguity. In order to ensure it remains possible to report costs for a standardised period of account, we recommend that the words "for that period" in rules 19.8.5 R (1) and (3) should be deleted in order that they are not miss-interpreted as overriding the assumption. This would ensure consistency with the PRIIPs RTS which requires cost figures to be calculated once a year, by reference to the PRIIP's accounting period, unless there is a material change in the cost base.

Q6: Do you agree that the approach set out in this chapter is adequate to provide governance bodies with sufficient information to assess transaction costs? If not, what alternative(s) would you propose?

Yes, we agree it is adequate. Notwithstanding our comments in response to other questions regarding the FCA's methodology, the FCA is specific about the scope of transaction costs. We are in the process of developing and will shortly be consulting publicly on a format for presenting transaction cost information to interested parties. This forms part of a wider disclosure code that we intend will include specifications in respect of best execution, payments for research and pricing policies. We would like to work with client groups and the FCA to ensure that this code is recognised as the authoritative framework for discharging disclosure obligations pertaining to the costs of asset and fund management.

Q7: Do you have any comments on our analysis of the costs and benefits of introducing rules on transaction cost disclosure?

Cost benefit analyses are inherently challenging. As a matter of general principle, we agree that a standardised approach to reporting is preferable from both a consistency perspective, and in the interests of cost effectiveness, given the challenges in reporting in different ways to different client groups. It is partly for this reason that we are developing our new disclosure code across the wider investment products and services market.

However, we have significant concerns that the analysis provided combines the two separate and independent parts of the FCA's solution (paragraph 19): the overall costs of standardised vs ad hoc reporting of transaction costs; and the costs of calculating transaction costs. In the latter respect, based on the reliance on information from transaction cost analysis firms (paragraph 23 of the analysis) and the statement in paragraph 6.3 that explicit costs are already reported to governance bodies, we assume the costs of calculation relate solely to the incremental costs of calculating implicit costs. In our view the welcome benefits of using a standardised approach to reporting will be realised regardless of how the calculation of implicit costs is defined.

According to the analysis, responding to ad hoc requests costs £8.3m per year and responding to standardised requests will cost nothing on an ongoing basis. In reality there

will be an ongoing cost after standardisation but we agree there will be significant cost savings. These savings will be achieved through a one-off investment of £13.5m to build automated reporting systems. Together these figures imply a payback period of 20 months and a net saving of £28m over five years. If these economics are correct, these benefits will be realised regardless of the definition used for the calculation of implicit costs.



Separately, the FCA has estimated that sourcing the data for the slippage method of calculating implicit transaction costs will cost managers £0.1m upfront and then £0.8m per year but there is no consideration of the cost of implementing a different methodology, such as using spread. This gives rise to a cost of £4m over five years for no discernible benefit compared to other methodologies. Given that most managers already produce spread estimates on a frequent basis in order to set the parameters in their unit pricing systems, to inform their dealing decisions and, in the case of UK authorised funds, for disclosure in their audited financial statements, the costs of a spread-based approach would be negligible. Therefore, a spread methodology would provide considerable annual savings, and the same benefits, compared to the slippage methodology.

Another area of concern is the broader observation about the impact of reduced transaction costs. The FCA have estimated savings to consumers of £13m for each basis point reduction in transaction costs. However, there is no indication in the analysis of how calculating and disclosing slippage cost, rather than another estimate of implicit costs, will contribute to reducing transaction costs. In some cases, as we have highlighted in our answer to question three, the focus on slippage cost could be detrimental to net returns.

Furthermore, we would challenge the assumptions of 100% turnover for active funds that have been used. These do not appear to be based on empirical evidence. Our estimates, using independent data from Fitz Partners, suggest that turnover is significantly lower across the investment fund universe. For example, recent UK All Companies turnover is around 33% for active and 11% for tracker funds.³

Finally, we do not feel that the FCA has adequately factored in the costs of presenting such complex methodologies to scheme decision-makers. These costs could involve both time and production of materials as well as an adverse impact on confidence (eg. through the occurrence of negative costs). It is stated that improved disclosure of transaction costs will encourage greater confidence, but it is not shown that this outcome is independent of the nature of the disclosure. To be clear, we agree that removing the perception of 'hidden costs' is absolutely essential and that the pensions and investment industries need to be clearer in their presentation of charges and costs. However, confidence also depends upon accessibility, consistency and a degree of simplicity. The slippage methodology does not meet any of these tests in our view.

³ Investment Association / Fitz Partners, [Investment costs and performance: Empirical evidence of industry delivery](#), August 2016, pp.10-11.