THE TRANSPARENCY TASK FORCE

9th January 2017

Transparency Task Force Response to the FCA's Transaction Costs Disclosure in Workplace Pensions, Consultation Paper 16/30

1. The purpose and status of this document

This document has been put together by members of the Transparency Task Force (TTF) to provide input to the FCA's Transaction Cost Disclosure in Workplace Pensions Consultation Paper 16/30.

Whilst several members of our Costs & Charges Team have been involved in producing this document it should not be assumed that the views given reflect those of all members of the TTF as not all members of the TTF have been involved in producing it and some have contrarian views.

Of course, many of our members and the organisations they represent may feed in their thoughts to you independently of the TTF.

2. About the Transparency Task Force

The Transparency Task Force is the collaborative, campaigning community that is dedicated to driving up the levels of transparency in financial services, right around the world.

We believe that higher levels of transparency are a pre-requisite for fairer, safer and more efficient markets that deliver better value for money and better outcomes to the consumer.

Furthermore, because of the correlation between transparency, truthfulness and trustworthiness, we expect our work will help to repair the self-inflicted reputational damage the Financial Services sector has suffered for decades. We seek to effect the change that the financial services sector needs and the consumer deserves.

The TTF is free to consider what is ultimately best for the consumer without commercial conflicts and we are perhaps unique in being made up of a truly pan-industry cross-section of members, trade bodies and professional associations. As such we are well-placed to establish consensus that does not merely reflect the wishes of one particular "tribe" or another.

Our approach is collaborative - we seek a win/win/win; whereby consumers, market participants and the efficacy of government policy can all benefit from the work we do.

Market reaction has been extremely positive and supportive; so much so that in just 20 months we have developed six teams of volunteers, each team focused on a set of transparency-related issues and desired outcomes:

- The Market Integrity Team
- The Foreign Exchange Team
- The Banking Team
- The Costs & Charges Team
- The Stewardship & Decision-Making Team
- The International Best Practice Team

The topic of 'Transaction Costs in Workplace Pensions' is of great interest and relevance to our Costs & Charges Team.

3. About the focus of our response

As the Transparency Task Force is the collaborative, campaigning community dedicated to driving up the levels of transparency in financial services, right around the world, we are in general terms extremely pleased with the thrust of CP 16/30 and believe that it represents a tremendous opportunity for the market to embrace much-needed enhanced costs disclosure.

Our over-riding view is that we wish to encourage the FCA to utilise CP 16/30 to be a catalyst for consistent reporting and disclosure to areas beyond workplace pensions and beyond just asset management transaction costs; costs occur throughout the value chain.

The ultimate objective must surely be to provide fully comprehensive cost disclosure with consistent and 'un-gameable' reporting, throughout the 'value chain'; with information being provided in a clear and intelligible manner. Only once this has been achieved will the market operate efficiently and the consumer be able to maximise value-for-money.

As discussed at our meeting with the FCA on 8th December, there is much that we like in CP 16/30. However, the focus of our response is on what improvements we think can be made and as such we list many areas where further consideration ought to be given. As requested we set these out in response to the specific questions that have been asked:

4. Response to Questions 1 to 7

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?

- The lack of consistency and detail in the proposed rules will likely not result in governance bodies getting relevant information and comparable data on which they can take relevant actions.
- We propose that a standardised approach would include:
    - Standardised reporting periods, say calendar months; and
    - Standardised reporting templates, as called for in MS15/2.2, based on standardised definitions.
- The approach proposed in CP16/30 risks some service providers ‘gaming the system’, given the lack of consistency/standardisation, ultimately eroding trust in the financial sector.

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

- The approach is inconsistent across asset classes, as discussed in greater detail in our response to Q3 below. It is also open to manipulation by those providing the data.
- We consider that further consumer detriment and loss of trust in the system will be the end-result of the slippage cost proposal.
- The slippage cost proposal is open to being gamed, more specifically:

1. The mid-market price is not necessarily the price at which an asset is valued immediately before an order is placed into the market.
    a. The bid and offer prices quoted in a market are often not true indications of where the parties are willing to trade but merely a means of discovering where others hitting the bid/offer are willing to trade;
    b. Paragraph 3.23 notes that “if we cannot define in a clear and robust way what constitutes spread, there is likely to be a high degree of inconsistency in the market about how spread is calculated”. If the spread cannot be calculated in an indisputable way, how can the mid-market/arrival price be calculated?

2. Another form of inconsistent treatment arises where previous closing prices are used to determine the arrival price.

    If, for example, a market gaps down between the previous close and the point of trade, a negative slippage cost would be returned as the execution cost would be below the arrival price.

    This loophole might encourage managers to trade in order to reduce a fund’s reported slippage cost over the period even if there is no fundamental benefit to the client.

3. Paragraph 3.19 states “the market has developed in a heterogeneous manner and there is no single standardised way in which transaction costs are analysed”.

    We suggest that this lack of standardisation is a reflection of the impossibility of trying to calculate implicit costs.

- We propose an approach based on the following guiding principles:
  - Consistency across all assets;
  - Simplicity of implementation; and
  - Ease of communication.

We suggest excluding implicit transaction costs entirely while creating a distinct boundary between the principals (i.e. buyer and seller) and agents (who levy transaction costs) to eliminate conflict of interests. The resulting proposal is as follows:

1. The transaction price represents the payment by the buyer to the seller for the ownership of the asset exclusively. No other payments would be permitted to be bundled into the transaction price. The seller would have to be unrelated to any agent involved in the transaction in order to avoid the potential for embedding cross-subsidies in the transaction price; and

2. All other costs, charges and taxes would need to be explicitly levied. Ideally, the FCA would specify the types of costs and charges permitted (and required at a minimum) to be levied. Such specification would create the basis for consistent reporting of costs and charges. The minimum requirement would cover those services, and related costs, common to all transaction types (e.g. brokerage, transfer agency and custody etc.) in order to avoid these costs being hidden in the price.

We are aware that some markets do not currently disclose transaction prices that exclusively represent payment for the ownership of the asset. In many cases, transaction costs are bundled into the disclosed transaction price. Changes are required to conduct in these markets to deliver the proposed boundary.

Other points:

- Use the most accurate approach per asset class/instrument and not just Slippage Cost as the core methodology.
- The likes of illiquid asset classes (such as private market assets – which range from real estate, infrastructure to private equity investments in companies) need to be addressed within the framework. These are increasingly be utilized by long-term investors. In particular, structures such as Private Equity (PE) cannot be out of scope for transaction costs reporting. PE funds are now actively part of asset management solutions in the DC pensions' space with PE pooled funds being used by Diversified Growth Funds.
- Specific areas not consistently captured for PE in terms of transaction costs covers those transaction costs for completed deals and broken deals (where the deal does not complete but transaction costs are incurred. Broken deal transaction costs may include the costs of the deal (i.e. professional fees, travel, out of pocket and other expenses).

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

- The proposals in this chapter illustrate the inherent flaws of the slippage cost approach, as set out in our response to Q2. The raft of asset class-specific proposals highlights the issue that consistent implementation is not possible. This inconsistency will result in distorted reporting and manipulation, undermining the proposed rules and likely resulting in consumer detriment.

Other points:

- Some transaction types may have been missed in the report. For example, trade-based rebates are common in the US currently as fierce competition between exchanges has led to rebates being increased. Rebates are payable from the exchange to the originating broker. Asset managers are trying to claim these rebates from the brokers but are all rebates finding their way back from the asset manager to the investor who originated the transaction?

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?

- The proposed rules, requiring look-through to the underlying vehicles, are likely to be supportive of amalgamation of total transaction costs.
- Consistency of what is disclosed and timing of disclosure are two other necessary conditions to enable amalgamation.

Other points:

- As mentioned earlier, the FCA is proposing that asset management firms can use an “open format” to report transaction costs. The use of open formats will mean that transaction cost information may be reported differently across asset management groups. Should this happen, how will investors be able to compare similar investment products?
- In addition, many DC investment solutions offered by asset managers may use a multi-level fund structure with a multi-manager component underneath. Should each asset manager in such a structure be allowed to use a different reporting format, then when transaction costs are further consolidated into one number or one set of numbers (by the asset manager of the overall fund), how will the investor know what they have received and will it make sense if decomposed?

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?

- Transaction costs will likely not be evenly incurred over a reporting period.
- A balance needs to be found between frequency of reporting and the value of such additional reporting.
- We propose monthly reporting periods but with a measurement frequency that is, ideally, aligned with the frequency at which the underlying funds are traded.

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?

- We do not consider that the proposed approach is adequate to provide governance bodies with sufficient information to assess transaction costs because of the absence of a standardised approach.
- There seems to be an inconsistency in the approach proposed in CP16/30 with the thinking set out in in MS15/2.2 that called for standardised reporting templates.
- We propose that standard reporting templates, based on uniform definitions, prescribed presentation of data (showing costs in absolute and percentage terms) and specified reporting periods (say monthly) be introduced.
- Standardisation will ensure that governance bodies are able to easily and efficiently aggregate information from across all their service providers. Standardisation will also drive economies of scale and efficiencies for the providers of such information.
- Please find attached the latest iteration of the TTF's '6 x 6 Costs Matrix) and see rows 304 to 358 which relate to transaction costs, with rows 311 to 313 relating to implicit costs that cannot be calculated. We are part way through an exercise to define the terms used. Definitions are extremely important; a point we shall return to later in this response.

Other points:

- Some transaction types may be missing from the FCA's analysis. Certain transaction types may take place at the feeder fund level in a pooled fund. These transaction types need to be considered as they may interact with revenues taken from bid/offer or swing pricing on the pooled fund units or they may lead to portfolio turnover in the master fund.

- When investors subscribe for pooled fund units, there can be a delay of a day or many days between the investor making payment and the fund administrator then paying those funds away to purchase the units. Any delays represent a transaction cost as interest is lost on the amount being paid. The same delays and transaction costs may apply when redeeming units too.

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

- We consider the estimate that the costs of calculating transaction costs using the 'slippage cost' method (a one-off amount of £125,000 and an annual cost of £775,000) is a significant under-estimate.

Other points:

- Most medium and large asset management groups use a data hub/data repository to feed trading, accounting and other investment systems. Use of the data hub to drive transaction costs reporting will likely reduce transaction cost reporting development costs as reports may not have to be written in OMS/trading or accounting systems via dedicated reports developed by software vendors. It is likely that asset managers with data hubs may find it less expensive to develop these reports than the FCA believes.

5. Other matters

We would like to offer input beyond the scope of the specific questions asked:

1. Definitions

It is absolutely vital that all terms used are clearly defined. There is a myriad of other over-lapping regulatory and industry body initiatives that are underway. These initiatives include the new IA Disclosure Code, PRIIPS, FCA Asset Management Review, MiFID II and others. Some of these initiatives clearly define the terms that they have used and certain terms may be defined in different ways.

CP16/30 should have a Glossary of terms used with each term being clearly defined. Clear definition of each term will ensure consistency across regulatory and industry body initiatives which will, in turn, lead to a strong set of regulations that reduces the risk of ambiguity and, therefore, the risk of the transaction cost regulations being gamed/undermined and consumer confidence being lost.

The list of terms that require clear definition in the CP16/30 document are outlined below and are not in any particular order. Where a definition is applied differently, for example, by asset class then this should be clearly and completely stated. All terms should appear in a central Glossary so that they can be referenced with ease.

- Order
- Transaction
- Transaction Costs
- Implicit Transaction Costs
- Explicit Transaction Costs
- Enters the Market
- Arrival Price
- PRIIPS
- MiFID II
- Multi-asset Funds
- Default Arrangement
- Slippage Cost
- Delay Cost
- Opportunity Cost
- Negative Transaction Costs
- VWAP
- Market Impact
- Auction
- Price Transparency
- Linear Derivatives
- Non-linear Derivatives

The Transparency Task Force is part way through a definitions exercise and would welcome specific dialogue with the FCA on this work; we believe that a centralised and systematic approach to establishing definitions is a worthwhile aim and we shall follow up with some ideas on this separately.

2. Swing Pricing

In relation to the points made in 2.8 and 5.4 within CP 16/30, it is important to note that MIFID does not seem to consider swing pricing a transaction cost, so this could introduce difference in MIFID disclosure and disclosure under CP 16/30, and we would rather have consistency. In addition, as 5.4. of the CP states, this could result in a negative fee. However, we would have no objection to funds disclosing the maximum amount of any swing the fund price could incur.

3. Foreign Exchange

We are pleased that the FCA highlighted the importance of execution method in determining costs. The execution method includes choice of broker, whether to use a fixing, which platform to select and so on. The FCA now requires that the whole of this method is measured, and we fully support this approach.

We also broadly support the stipulation that costs be measured against consolidated prices. In our view, however, this does not go far enough as it would allow the user of a multi-contributor platform to use the consolidated rate received through that platform as the reference rate to measure the quality of their transactions. This presents two issues. Firstly, the referencing is circular, and fails to measure the inherent cost of choosing that platform. Secondly, it is quite clear that underlying price providers are able to skew prices towards clients through aggregated platforms. The information asymmetry inherent in these platforms can only be measured by using a consolidated rate that includes prices from other platforms.

We believe that investor protection would be enhanced if the FCA made this requirement explicit. Annex IV, article 17 of the PRIIPS regulations offers a good template to follow:

"In calculating the costs associated with foreign exchange, the arrival price must reflect a reasonable estimate of the consolidated price, and must not simply be the price available from a single counterparty or foreign exchange platform, even if an agreement exists to undertake all foreign exchange transactions with a single counterparty".

4. The Importance of Cohesion

CP 16/30 has limited scope. There are many areas of the pensions and investment industry that give rise to costs to the investor that are not covered by CP16/30 or the Market Study. As such, the TTF consider that the drive towards transparency should be broader, with CP16/30 and the Market Study acting as a catalyst.

The ultimate objective as we see it is to achieve what is really needed for the market to work efficiently and for the consumer's interests to be best served i.e. fully comprehensive cost disclosure that takes into account all parts of supply chain.

We see there is a risk of a fragmented approach being taken (for example there is inconsistency between CP 16/30 and the Market Study) and would welcome all relevant parts of the FCA, DWP and The Pensions Regulator working as cohesively as possible.

6. Final thoughts

The Transparency Task Force is highly appreciative of the excellent work that the FCA has undertaken, as set out in CP16/30 and also in its Asset Management Market Study (Interim Report).

We can see that there is an opportunity for significant progress being made on how costs are disclosed, and in particular we feel that the FCA's intention to set standards to provide clarity around transaction costs is very important.

Also, we wholeheartedly agree with the FCA's objectives of creating a regime that achieves a high degree of consistency in how transaction costs are reported, and gives governance bodies confidence that the information presented to them contains a comprehensive assessment of the costs that are incurred on their behalf by asset managers.

We hope that our response to CP16/30 has provided worthwhile input that may assist the FCA in achieving those objectives. We are happy to have on-going dialogue on the matters raised, and if there are areas where the FCA is particularly keen to have examples we will seek to assist where we can.

As mentioned earlier, our over-riding view is that we wish to encourage the FCA to utilise CP 16/30 to be a catalyst for consistent reporting and disclosure to areas beyond workplace pensions and beyond just asset management transaction costs; costs occur throughout the value chain.

The ultimate objective must surely be to provide fully comprehensive cost disclosure with consistent and 'un-gameable' reporting, throughout the 'value chain'; with information being provided in a clear and intelligible manner. Only once this has been achieved will the market operate efficiently and the consumer be able to maximise value-for-money.

This is certainly the vision of the Transparency Task Force on this matter.

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