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By U.S. Mail and Email: cp16-30@fca.org.uk

Mr. Michael Collins
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Re: FCA Consultation Paper on Transaction Cost Disclosure in Workplace Pensions - CP16/30

Ladies and Gentlemen:

The Asset Management Group of the Securities Industry and Financial Markets Association ("AMG") appreciates the opportunity to comment on the proposed guidance and rules (the "Proposed Rule") of the Financial Conduct Authority ("FCA") on the disclosure of transaction costs in workplace pensions set forth in its recent Consultation Paper on Transaction Cost Disclosure in Workplace Pensions (the "Consultation").[1] AMG members are U.S., U.K. and multinational asset management firms with combined global assets under management exceeding $34 trillion. The clients of AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS, and private funds such as hedge funds and private equity funds.

AMG understands the FCA's goal to establish standardized disclosures of pension investment transaction costs and make them available to independent governance committees and trustees of plans. Further, AMG agrees with the underlying objectives of the Proposed Rule, namely to deliver a high degree of consistency in how transaction costs are reported, and to provide 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. However, AMG believes that the imprecision and variability of the slippage cost methodology will have a result precisely the opposite of its purpose: varying results across managers even for trades in the same securities at the same time, substantial variation and confusion on the treatment of cash flows, and virtually no useful metrics in markets, such as OTC options, derivatives, and to a large extent, fixed income, where price reporting is not robust.

Similar proposals have been considered and ultimately rejected by U.S. regulators for more than a decade. The comments set forth below reflect the issues and concerns that were considered by U.S. regulators in similar contexts, and that apply equally to the Proposed Rule. AMG submits that use of the slippage cost methodology will not provide uniformity, clarity, or precision, largely because of the nature of the markets, and will be potentially misleading to plan fiduciaries, thereby undermining the purpose of the Proposed Rule.

[1] FINANCIAL CONDUCT AUTHORITY, CP16/30, TRANSACTION COST DISCLOSURE IN WORKPLACE PENSIONS (2016), *available at* https://www.fca.org.uk/publication/consultation/cp16-30.pdf.

A. BACKGROUND – THE U.S. EXPERIENCE

U.S. regulators have considered, and rejected, proposals that are similar to the slippage cost methodology for more than a decade. In 2003, the Securities and Exchange Commission (the "SEC") issued a concept release (the "2003 SEC Concept Release") that sought public comment on ways to improve the disclosure of mutual fund transaction costs, specifically whether mutual funds should be required to quantify and disclose transaction costs.[2] In the 2003 SEC Concept Release, the SEC recognized that market impact cost cannot be calculated directly, and can only be roughly estimated by comparing the actual price at which a trade was executed to prices that were present in the market at or near the time of the trade. The SEC further acknowledged that spread, impact, and opportunity costs are implicit costs. Because the implicit costs, which are difficult to identify and quantify, can greatly exceed the explicit costs, there is no generally agreed-upon method to calculate securities transaction costs.

Shortly thereafter, as a result of discussions between the SEC and the National Association of Securities Dealers (the "NASD"), the NASD formed a task force to further consider ways to improve the transparency of mutual fund portfolio transaction costs and distribution arrangements.[3] Although the task force recommended that the SEC enhance disclosures concerning portfolio transaction costs, the task force specifically declined to recommend quantitative disclosure of intangible transaction costs, such as market impact and opportunity costs, stating that implicit portfolio transaction costs, such as the execution costs associated with principal trades executed on a net basis, market impact costs, and opportunity costs, are far more difficult to measure and quantify than total commission amounts.

The SEC again echoed this position in 2009 when it amended rules regarding mutual fund prospectus disclosures (the "Summary Prospectus").[4] In the Summary Prospectus, the SEC considered requiring the impact of transaction costs to be reflected in a fund's expense ratio in the fee table, but rejected that suggestion as being infeasible to implement at the time, noting that the rulemaking process did not provide an adequate basis for prescribing a specific and accurate methodology for reflecting transaction costs in a fund's expense ratio.

The U.S. Department of Labor (the "DOL") underwent a similar analysis in 2006 when it proposed a rule that would have required service providers to report all transaction costs incurred by the plan-to-plan sponsors, who then would have been required to attach such disclosure to the plan's annual report which is publicly disclosed. Ultimately, the DOL concluded that these requirements would not be helpful to plans that are managed by professional asset managers. Commenters argued that requiring plans to report on a broker-by-broker basis the gross dollar amount of commissions and fees paid during a plan year made no sense. Reporting gross amounts by broker would not help the plan's fiduciaries determine whether trades executed by a particular broker were initiated by one manager or multiple managers, whether any of the managers used good judgment in selecting the broker-dealer, whether best execution was achieved, whether the plan received a low commission rate or a high commission rate on a specific trade, or whether a manager churned the plan's account by engaging in unnecessary transactions with a number of different brokers. A high gross

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[2] Request for Comments on Measures To Improve Disclosure of Mutual Fund Transaction Costs, 68 Fed. Reg. 74,820 (Dec. 24, 2003), *available at* https://www.gpo.gov/fdsys/pkg/FR-2003-12-24/pdf/03-31695.pdf.

[3] NASD, REPORT OF THE MUTUAL FUND TASK FORCE ON SOFT DOLLARS AND PORTFOLIO TRANSACTION COSTS (2004), *available at* http://www.finra.org/sites/default/files/Industry/p012356.pdf.

[4] Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4,546 (Jan. 26, 2009), *available at* https://www.gpo.gov/fdsys/pkg/FR-2009-01-26/pdf/E9-1035.pdf.

amount could mean a number of different things, such as many trades in emerging markets, mostly agency trades, difficult to assemble blocks of securities, or unfavorable commission rates. A low gross amount could mean favorable commission rates, many principal trades, or that many of the plan's managers used a "buy and hold" strategy rather than a frequent trading investment strategy. The DOL's proposed reporting of gross amounts by broker would also not help fiduciaries understand an investment manager's trading decisions, the comparability of different brokers, or whether efficient trading has occurred.[5] In rejecting the proposal, the DOL stated that brokerage costs associated with a broker-dealer effecting securities transactions within the portfolio of a mutual fund, or for the portfolio of an investment fund managed by a professional asset manager that holds plan assets for ERISA purposes, should be treated as an operating expense of the investment fund and not as reportable indirect compensation and, therefore, need not be disclosed by the service provider to the plan.[6]

The experience of U.S. regulators can help inform the FCA in developing the Proposed Rule, particularly given the breadth and depth of their experience—multiple bodies considered the issues several times over a period of many years. The comments below describe concerns that were considered by U.S. regulators in similar contexts.

B. LACK OF UNIFORMITY

The Proposed Rule would require that transaction costs be disclosed using what it describes as a "slippage cost" approach based on a comparison of actual prices with the value of the asset immediately before the buy or sell order is placed. The general principle of this approach is that the transaction cost is the difference between the price at which an asset is valued immediately before an order is placed into the market and the price at which it is actually traded. Unfortunately, a reference to a price immediately before the transaction permits a wide variation in the term "immediately" and depends on the existence of intraday and uniform price reporting across markets, which does not exist. Specifically, in OTC markets, dealers will give different prices to different participants for a variety of reasons. For example, a manager may get skewed quotes (i.e., not around a "fair" mid price but instead slanted high or low) depending on such factors as whether the dealers whom they call have inventory that they are keen to dispose of or whether the dealers are anticipating additional demand in a given direction. A different manager may at the same time call another set of dealers who are not skewing their quotes. Any reference that depends on dealer quotes will necessarily skew any accuracy and precision in results. Therefore, AMG submits that the slippage cost approach will result in a lack of uniformity in how transaction costs are disclosed, thereby failing to advance the FCA's goal of standardizing the disclosure of transaction costs.

There is no universal method for assessing slippage; therefore, asset managers will not calculate costs in the same manner. As a result, their calculations will be subjective and arbitrary. For example, some managers may find a dealer to provide pricing immediately before the trade, while others may be using yesterday's close or today's open. As a result, for the exact same trade, with the same dealer at the same price, the transaction costs will differ solely because of these varying reference points. And this difference, which will be deemed "transaction costs," will be erroneous and confusing.

[5] Securities Industry and Financial Markets Association Comments to the Employee Benefits Security Administration of the U.S. Department of Labor relating to a proposed revision to the Annual Information Return/Reports (Form 5500), RIN 1210-AB06 (Dec. 27, 2006), *available at* https://www.sifma.org/comment-letters/2006/sifma-submits-comments-to-the-us-department-of-labor-on-proposed-changes-to-form-5500/.

[6] EMP. BENEFITS SEC. ADMIN., U.S. DEP'T OF LABOR, FREQUENTLY ASKED QUESTIONS ABOUT THE 2009 FORM 5500 SCHEDULE C (2008), *available at* https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/schedulec.pdf.

Further, asset managers will not rely on the same underlying data to calculate costs. Because cost calculations will not be based on a consistent body of underlying data across asset managers and asset classes, plans will not be able to make meaningful comparisons between reported costs. Many managers may not have the necessary data (such as intraday/tick level arrival price data) to perform the calculations. For example, intraday data is not available for OTC markets, and other securities are thinly traded and not publicly reported. As a result, the mid price will be highly subjective, depending on who provides an indicative bid.

Dealers providing bids under these circumstances are also likely to provide indicative prices that are less precise, as opposed to real prices, because they realize that the request for bids or offers is for transaction cost calculation purposes and not in connection with a real trade. Once dealers understand that these quotes will be used for reporting, rather than trading, the quotes will bear little relationship to real prices or prices at which the dealer might actually trade. Indicative quotes will undermine any reliability this transaction cost reporting might have had.[7]

Where intraday market prices are not easily available, the Consultation proposes that firms use the last available mid price, which may be the opening price, or the previous closing price where no subsequent price is available. For securities traded on an exchange, the last price is not generally a mid price but simply a price at which the last trade was made. In fixed income, OTC options, derivatives and other markets, the concept of an opening price or a closing price is a false comfort; there is no widely accepted opening or closing price. Furthermore, when using reference prices which are far away from actual execution times, significant noise is introduced in the slippage estimate as information and flows affect market prices outside of the managers' control.

Finally, there are many appropriate benchmarks to measure market impact in various ways, all of which would result in significantly different (and non-comparable) results. An asset manager's measure of transaction costs may also differ based on whether costs are inclusive of aspects of portfolio management and trading unrelated to outright changes in market views, including rolling derivative contracts and other operational dynamics, such as currency sweeps. The removal of flows will also contribute to a lack of uniformity; trading due to flows can lead to higher turnover and transaction costs relative to a period of smaller flows, and disentangling inflows and outflows is a time consuming and not straightforward process.[8]

C. MISLEADING DISCLOSURES

The Proposed Rule will result in confusion because the slippage cost approach for calculating transaction costs does not provide a meaningful assessment of management performance, and in fact may

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[7] In contrast, a rule such as this might work in the exchange traded equity markets if the reference price were always the closing price on the exchange from the day before. That price would then put all managers holding the security on a level playing field. No such level playing field is possible in most other markets.

[8] Similar concerns were raised in response to the 2003 SEC Concept Release. Commenters noted that the methodologies used to measure implicit transaction costs employ a wide variety of estimation techniques and lack uniformity. Such measurements involve judgment and calculation methodologies that differ from one consultant to another and, in most cases, the methodologies are considered proprietary information. This absence of uniformity and baseline measurements do not serve to facilitate comparisons among funds and, therefore, would be of limited use to investors. *See* Comment Letter from the Investment Company Committee of the Securities Industry Association in response to the 2003 SEC Concept Release regarding measures to improve disclosure of mutual fund transaction costs, File No. S7-29-03 (Feb. 20, 2004) [hereinafter "SIA Comment Letter"], *available at* http://www.sifma.org/comment-letters/2004/sia-submits-comments-to-the-sec-on-improving-disclosure-of-mutual-funds-transaction-costs/.

mislead investors who will erroneously assume that lower transaction costs mean better management. The resulting disclosures based on the slippage cost methodology will not reflect the quality of trading, the liquidity of the asset, or the development of the market, nor will they distinguish between foreign exchange, liquid fixed income, or illiquid fixed income. There are several reasons for this.

First, the methodology and resources for measuring transaction costs can vary even among asset managers implementing similar strategies. As a result, clients may be confused and may draw conclusions that are entirely at odds with the transaction cost reporting that they have traditionally enjoyed. For example, plan fiduciaries may presume that past estimates of transaction costs are valid indicators of future transaction costs, which may not be a good assumption in light of changes in market conditions, available instruments, technological tools, and other relevant factors. Separating transaction costs or implementation costs also implies that there is always a distinction between the investment strategy and the implementation. It implies that the trading or implementation aspect is a commodity that is capable of being delivered by any competent asset manager and appropriately compared from asset manager to asset manager. While some asset managers or some strategies may lend themselves to a comparable model, it is clearly an overstatement to say that such a comparison applies to all asset managers or strategies. In addition, while not separately reported, transaction costs are already incorporated into the total economic return for investors. Asset managers have a strong incentive to minimize transaction costs that might otherwise reduce those returns, so interests between plan fiduciaries and asset managers are already aligned.

Second, disclosures that are based on the slippage cost methodology will not reflect the underlying strategy that is being utilized. Costs differ based on strategy, but the slippage cost methodology does not account for differences in strategy. In some cases, higher transaction costs are required to exploit the underlying strategy. The slippage cost approach disaggregates strategy from delivery, and provides no context for the trade. As a result, the level of measured transaction costs across different strategies (e.g., medium-to-long-term trend following vs. a short-term commodity trading advisor strategy) will yield vastly different results, and will not be comparable as it relates to assessing the quality of management. For example, one strategy may be to break a single order into a series of sub-orders over the course of a day or several days in order to obtain the best price. If asset managers reset the "arrival price" for sub-orders belonging to the same parent order, or at the start of each trading session, the resulting transaction costs will be skewed.

Third, the disclosures will favor certain strategies over others. For example, illiquid strategies will always appear to have higher trading costs than liquid securities under the slippage cost approach. Yet, that result is not meaningful nor rationally related to the purpose of the Proposed Rule. Similarly, managers with higher "alpha" will generally have higher transaction costs, and investors will erroneously assume that lower "alpha" means better management. This ignores the important fact that higher "alpha" would generally be considered better, not worse, for manager performance.

Fourth, asset managers already have a fiduciary duty to deal fairly and seek best execution for trades in client accounts. This obligation certainly is broader than mere slippage cost, particularly for instruments that are not traded on an exchange such as fixed-income securities. Other aspects such as counterparty risk, operational risk, willingness of dealers to commit capital, availability of electronic platforms, and conflicts of interest are generally considered depending on the facts and circumstances. While each trader may not have a formalistic checklist that shows their entire thought process through every trade for every potential factor, these are the kinds of factors that are usually in the mix and part of a trading decision. Reducing all of that to an estimate of transaction costs based on the slippage cost methodology is likely to inadequately reflect and potentially mislead the variety of relevant factors that are considered. Given the existing fiduciary obligations of asset managers, there is already an enforcement mechanism if an asset manager was to ignore its fiduciary duties and inappropriately incur excessive transaction costs on a client account.

Fifth, the disclosures may be particularly misleading for certain assets. For example, when the asset manager is one of a select group of holders, such as with emerging market sovereign bonds, the asset manager may move the market each time it trades. If a trade is the only trade of the day, it will be compared to itself, resulting in an inflated "transaction cost" that does not reflect the transaction cost of the trade at all. Similarly, the disclosures will be misleading as to unusual instruments. For example, they will not reflect the floor, hedge, and collar that may be imbedded in what was bought or sold to create that trade.

Sixth, the disclosures may result in transaction costs that are positive as a result of market shifts that are entirely unrelated to asset management decisions, further misleading investors. Thus, for example, assume in an illiquid market, a manager sells five securities. Assume further that the sales price is higher than the last price reported for each of the securities the night before. These five trades will have no transaction costs, or positive transaction costs. It is unclear how a plan fiduciary should analyze such discrepancies, since they are not, in fact, trading cost measurements at all.[9]

Boards, governments, media, the public, and many allocators do not necessarily understand the nuances in various ways of calculating the measures, nor whether larger costs are a good or bad thing. Given the lack of understanding, these various other entities will likely presume that lower transaction costs are objectively better, even if the calculation of those transaction costs under the slippage cost methodology is illusory and unconnected to strategy, the liquidity of the asset and the development of the market.

D. MARKET IMPACT

The FCA is essentially creating a rule that favors passive investing regardless of whether the active management has better net performance. The slippage cost methodology creates a disincentive to trade in order to appear to have a lower transaction cost. It may create an implicit incentive to hold a security longer than might otherwise be the case to avoid market impact or avoid contributing to additional transaction costs. Creating a disincentive for asset managers to trade on information disrupts the main purpose of markets which is to set prices of securities so that capital is allocated efficiently. Lower participation of active managers, or less trading from the active managers, leads to lower liquidity in markets that is inconsistent with the purpose of having open and public markets and exchanges. Most troubling, this creates incentives for plan fiduciaries to move from active to more passive (index) funds with less regard to trying to maximize net return for their plan participants.

E. POTENTIAL FOR ABUSE

The slippage cost approach is open to gaming and manipulation, particularly because the choice of dealers from whom to seek bids is left to each manager, and even without collusion or intentional gaming, sophisticated market participants will go to the dealer who will provide the best indicative pricing for the transaction cost calculation. For example, resetting the arrival price benchmark due to splitting an order generally leads to a lower measure of transaction costs relative to using a single arrival price benchmark for the same order with the same average execution price, leading managers to reset the arrival price solely for

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[9] A similar problem was identified in response to the 2003 SEC Concept Release. In a dealer market where trading is done on a principal basis, transaction costs are incurred when a fund buys a security at the asked price or sells a security at the bid price. Due to an efficient market, the spread includes imputed transaction-based compensation as well as any market impact and opportunity cost associated with the trade. In addition, institutional orders of significant size may have the effect of attracting other buyers and sellers, as the case may be, causing a change in price before the entire block is executed. These market impact and opportunity costs in many cases can exceed the commission or spread, demonstrating how potentially misleading (in terms of attempting to assess actual transaction costs) a straightforward comparison of actual commission costs or average commission rates can be. *See* SIA Comment Letter, *supra*, note 7.

this result. Similarly, some asset managers will use a neutral third party for values while others will self-estimate the values, further skewing the difference in the calculation across managers and further undermining the reliability of the data.

F. ALTERNATIVES

Given these concerns with the slippage cost methodology, AMG urges the FCA to consider alternative models, such as a modified version of the standards developed by the Dutch Pension Fund Federation. This system, which includes a spread-based methodology for implicit costs, would better reflect the nature of fees for spread-based products. We would welcome the opportunity to work with the FCA as it seeks to develop an alternative approach to the slippage methodology that would better achieve its goal of establishing standardized disclosures by asset managers of the transaction costs that pension investments incur, and improving the information available to independent governance committees and trustees of plans.

G. CONCLUSION

AMG again supports the FCA's efforts to create an appropriate methodology for providing governance bodies with the cost information necessary to meet their obligations, and we appreciate consideration of these comments. Please do not hesitate to contact either Tim Cameron at tcameron@sifma.org or Lindsey Keljo at lkeljo@sifma.org if you have any comments or questions regarding this letter.

Sincerely,

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