Financial Conduct Authority

Consultation Paper CP16/30**

Transaction cost disclosure in workplace pensions

October 2016

Contents

Abbreviations used in this paper 3

1 Overview 5

2 Facilitating the disclosure of transaction costs 9

3 Standardised calculation of transaction costs 12

4 Issues specific to asset classes 17

5 Proposed approach to amalgamating transaction costs at arrangement level 21

6 Presentation of transaction costs 23

Annexes

1 List of questions 26

2 Cost benefit analysis 27

3 Feedback from the Call for Evidence on Transaction Costs Disclosure (March 2015) 33

4 Compatibility statement 39

Appendix

1 Draft Handbook text 43

We are asking for comments on this Consultation Paper by 4 January 2017.

You can send them to us using the form on our website at:
www.fca.org.uk/cp16-30-response-form.

Or in writing to:

Michael Collins
Strategy and Competition Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Email: cp16-30@fca.org.uk

We have developed the policy in this consultation paper in the context of the existing UK and EU regulatory framework. We will keep the proposals under review to assess whether any amendments will be required due to changes in the UK regulatory framework, including as a result of any negotiations following the UK's vote to leave the EU.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

All our publications are available to download from www.fca.org.uk. If you would like to receive this paper in an alternative format, please call 020 7066 0790 or email publications_graphics@fca.org.uk or write to Editorial and Digital Department, Financial Conduct Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS

Abbreviations used in this paper

CBA	Cost benefit analysis
CP	Consultation Paper
DB	Defined benefit
DC	Defined contribution
DWP	Department for Work and Pensions
EU	European Union
FCA	Financial Conduct Authority
FSMA	Financial Services and Markets Act 2000
IGC	Independent governance committee
MiFID	The Markets in Financial Instruments Directive
MiFID II	The recast Markets in Financial Instruments Directive
OFT	Office of Fair Trading
PRIIPs	Packaged Retail and Insurance-based Investment Products Regulation
PS	Policy Statement
PTR	Portfolio turnover rate
TPR	The Pensions Regulator
VWAP	Volume-weighted average price

1. Overview

Introduction

1.1 This Consultation Paper (CP) proposes rules and guidance to improve the disclosure of transaction costs in workplace pensions. It sets out standards to enable independent governance committees (IGCs) and trustees[1] to obtain, for the first time, a standardised disclosure of the transaction costs that pension investments incur.

1.2 This CP has been written in the context of a number of regulatory initiatives in the pensions and investment sectors. Although each of these initiatives addresses different objectives and segments of the market, we are mindful of the benefits of a consistent approach to the disclosure of costs and charges whenever possible. In this CP, we focus on the specific area of transaction costs and propose creating a framework that can be used, where appropriate, to support other relevant regulatory initiatives.

1.3 The Financial Conduct Authority (FCA) is currently undertaking a market study into the asset management sector. Its terms of reference were published last year.[2] This market study is conducting broad analysis of a number of questions about the asset management value chain that are relevant to this CP, including: whether investors find it difficult to monitor asset managers and ensure they are getting value for money; and whether asset managers have the incentive and ability to effectively control costs incurred on behalf of investors.

1.4 The European Union (EU) has passed a Regulation[3] on key information documents for packaged retail and insurance-based investment products (PRIIPs). This establishes standard disclosure obligations, including a requirement to disclose transaction costs for those products in its scope.[4] This CP has been written bearing in mind the proposed requirements under PRIIPs.[5]

1.5 Governance bodies of pension schemes have a duty to request and report on transaction costs as far as they are able.[6] Without a matching duty on asset managers to provide full disclosure of these costs in a standardised form, scheme governance bodies may not be able to perform their function of assessing whether scheme members are receiving value for money. The FCA and the Department for Work and Pensions (DWP) will also be mandated to make rules and regulations to ensure disclosure of transaction costs by section 44 of the Pensions Act 2014, when it enters into force.

1 We refer to these collectively in this paper as 'governance bodies' of pension schemes.
2 www.fca.org.uk/publication/market-studies/ms15-02-1.pdf.
3 Regulation EU 1286/2014 – eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R1286.
4 Information about the FCA's understanding of the scope of PRIIPs is set out on the following web page: www.fca.org.uk/firms/priips-disclosure-key-information-documents.
5 We are monitoring the current situation around the Regulatory Technical Standards for PRIIPs, which have recently been rejected by the European Parliament, and, where appropriate, the final rules will reflect any relevant developments.
6 COBS19.5.5R and The Occupational Pension Schemes (Charges and Governance) Regulations 2015 (SI2015/879).

1.6 Currently, there is no standardised disclosure for reporting information about some types of transaction costs. The rules that we propose in this paper aim to set standards to provide clarity around these costs. In doing so, we have considered how to create a regime that achieves two important objectives:

- delivering a high degree of consistency in how transaction costs are reported, and
- giving 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

1.7 At the same time, in an area that is sometimes seen as highly complex, we propose to adopt a regulatory approach that is based on a straightforward principle, enabling universal application and keeping down the costs of implementation.

1.8 We have developed the policy in this CP in the context of the existing UK and EU regulatory framework. We will keep the proposals under review to assess whether any amendments will be required due to changes in the UK regulatory framework, including as a result of any negotiations following the UK's vote to leave the EU.

Who does this consultation affect?

1.9 This consultation affects those who are involved in the defined contribution (DC) workplace pensions market. This includes those who provide services in that market, such as pension providers and asset managers, and governance bodies of pension schemes, such as trustees and IGCs.

Is this of interest to consumers?

1.10 This work will indirectly affect all members of workplace pension schemes subject to the new governance requirements (who are, essentially, members of DC workplace pension schemes and DC parts of hybrid workplace pension schemes). The governance bodies responsible for overseeing their investments will get more information about transaction costs.

Context

1.11 In the DWP Command Paper *Better workplace pensions: further measures for savers* (March 2014)[7], the Government outlined measures for workplace schemes to give full transparency of all costs and charges. These will enable scheme managers and governance bodies to compare across the market and identify the best deal for scheme members. This followed an Office of Fair Trading (OFT) review[8] into the DC workplace pensions market that identified significant issues and made recommendations to improve the functioning of the market.

7 www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf.

8 Defined contribution workplace pension market study (OFT, 2013). Available at webarchive.nationalarchives.gov.uk/20131101164215/http:/www.oft.gov.uk/shared_oft/market-studies/oft1505.

1.12 The following year, the DWP's Charges and Governance Regulations and FCA rules for IGCs each imposed a duty on governance bodies to report on the level of transaction costs in their schemes. Trustees must do so via their Chair's Statement and IGCs via the IGC Annual Report. They are also required to report on the value for money of these costs. No equivalent duty was placed on asset managers to report the costs to scheme governance bodies. This places a burden on asset managers to respond on an ad hoc basis to inconsistently expressed requests for information about transaction costs.

1.13 Section 44 of the Pensions Act 2014 will also place a duty on the FCA and DWP to require information about transaction costs to be disclosed and published. Our view is that, in the first instance, information will need to be passed to IGCs and pension scheme trustees in a standardised way.

1.14 The FCA and DWP published a joint Call for Evidence[9] in March 2015, seeking stakeholder views on transaction cost disclosure. We also commissioned and published independent research from transaction cost analysis firm Novarca.[10] We undertook an extensive stakeholder engagement programme to seek views, particularly about the technical issues of calculating and amalgamating transaction costs.[11]

1.15 This work is mirrored by requirements under the EU PRIIPs Regulation[12] and the recast Markets in Financial Instruments Directive (MiFID II).[13] These require the disclosure of all indirect costs for relevant investment products, which are broadly all investment products, except for pensions. Transaction costs are one of the indirect costs of investment products.

1.16 Disclosing standardised and comparable transaction cost information to governance bodies represents the first step in making this information available to members. The FCA and DWP will, in due course, consider the legal measures needed to meet the other duties set out in Section 44 of the Pensions Act, to require the disclosure and publication of information about transaction costs.

1.17 The FCA is planning to publish the interim findings of our market study into the asset management sector later this year. This is reviewing a different, but related, set of issues compared to the OFT review into the DC workplace pensions market.

Summary of our proposals

1.18 The rules we are consulting on here set out a standard way in which transaction costs should be disclosed, using the approach described as slippage cost. They require those managing investments to report transaction costs in response to a request from a pension scheme, whether a workplace personal pension or an occupational pension, that is required to obtain them. We consider that this will lead to greater availability of transaction costs for governance bodies. Because Section 44 of the Pensions Act includes an equivalent duty to make rules around the publication of administration charges, these rules also include a requirement to provide administration charges in response to a request.

9 www.fca.org.uk/publications/discussion-papers/dp15-2-transaction-costs-disclosure-improving-transparency-workplace.
10 www.fca.org.uk/your-fca/documents/research/transaction-costs-transparency.
11 A summary of responses and our feedback on them may be found in Annex 3.
12 Article 8(f) of Regulation EU 1286/2014.
13 Article 24 of Directive 2014/65/EU.

Equality and diversity considerations

1.19 We have assessed the likely equality and diversity impacts of the proposals and do not think they give rise to any concerns. We would welcome your comments.

Next steps

What do you need to do next?

1.20 We want to know what you think of our proposals. Please send us your comments by 4 January 2017.

How?

1.21 Use the online response form on our website or write to us at the address on page 2.

What will we do?

1.22 We will consider your feedback and publish our rules in a Policy Statement (PS) in the second quarter of 2017.

2.
Facilitating the disclosure of transaction costs

Introduction

2.1 This chapter explains why we are making rules requiring asset managers to calculate transaction costs on workplace pension scheme investments and disclose them to their clients. It sets out how we expect these rules to give governance bodies of pension schemes the information they need to assess whether transaction costs offer value for money.

The structures of DC workplace pension schemes

2.2 Members of DC workplace pension schemes can usually choose between a default arrangement and one or more alternative investment options. Defaults are normally multi-asset funds and typically gain exposure to underlying assets by investing in a number of underlying funds. Other investment options involve investing in an individual fund, or investing in a different multi-asset arrangement which, in turn, invests in underlying funds.[14]

2.3 The structure of workplace pension schemes means that there are potentially a number of different parties involved in managing their assets. Disclosing transaction costs requires information that is not necessarily available to a firm directly providing services to a scheme. As such, it will be essential that the information is passed by those who hold it to those who need it.

2.4 In most DC schemes, investment management services are delivered through pooled arrangements (collective investment schemes or unit-linked insurance), although there may also be schemes where investment management is delivered via a mandate. The rules aim to ensure that information about transaction costs is passed to governance bodies (trustees and IGCs) in all circumstances.

How workplace pension schemes incur transaction costs

2.5 Because of the structure of pension schemes, as described above, there are different levels at which pension arrangements may incur transaction costs. Where an arrangement uses a fund of funds that then invests in underlying funds, the underlying funds incur transaction costs through investments in securities, while the fund of funds is likely to incur transaction costs when it buys and sells funds. Unless cost disclosure identifies both the transaction costs of

14 For clarity, we use the term 'underlying fund' in this paper to refer to an entity that holds assets, rather than an entity that holds investments in other funds.

the underlying funds and the transaction costs of funds of funds, it will provide only a partial picture of the transaction costs incurred by a pension arrangement.

2.6 There are also a number of reasons why pension schemes incur transaction costs. These could be the result of investment decisions or of money flowing into or out of a fund.

2.7 Transaction costs can be broken down into a number of broad categories:

- Costs for money flowing into or out of the fund because of pension scheme members contributing to their pension or leaving the scheme.
- Costs for members who make their own investment decisions switching between funds.
- Costs from switching activities as a result of investment decisions taken by the trustees or pension provider.
- Costs from investment decisions taken by the scheme's investment managers.

2.8 Costs involving money flowing into and out of the arrangements will be directly paid by the individual members responsible, rather than spread equally across all members. These costs are equivalent to entry and exit costs, and poor value for money here may have a material impact on the outcome for scheme members generally. We propose that such costs are not aggregated with other transaction costs, since they will be specific to individual members. However, if governance bodies request information about these costs, then we propose that firms should provide information about the typical and maximum levels of entry and exit costs (including typical swing prices) that members pay.

2.9 Governance bodies' analysis of the transaction costs for members switching may show how much this is impacting on member pension pots. We propose that such costs are not aggregated with other transaction costs, since they are specific to individual members.

How information needs to flow

2.10 The structure of the market means it is important that rules on the disclosure of transaction costs enable the flow of information to the governance bodies of those schemes. The consensus in the feedback to the Call for Evidence was that rules in this area need to have an effect on those who have the information about transaction costs.

2.11 In some cases, there will be arrangements where the information needs to flow between multiple parties to provide a full picture: for example, where an insurer uses a third-party fund-of-funds manager who then buys the funds of other investment managers. In these cases, it is essential that information flows between the various parties in a comprehensible form to reach the governance body that needs it.

2.12 For this reason, we consider it vital that rules requiring disclosure of transaction costs support this flow of information. While the ultimate responsibility to the trustee or IGC must continue to rest with the lead firm providing services, other firms providing services to the scheme must be obliged to provide the necessary information so that the governance body can carry out its function. The rules aim to make it clear that this is how information should flow. We propose an obligation to provide information in response to a request.

2.13 There may be some instances where service providers to the fund are outside the scope of these rules. In these cases, governance bodies or lead providers will need to seek information about transaction costs from firms who are not subject to our rules. We discuss this matter further in Chapter 6.

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?

3.
Standardised calculation of transaction costs

Introduction

3.1 This chapter considers the methodologies that might be used to calculate transaction costs. It explains why we have selected our proposed approach.

3.2 Transaction costs include both explicit costs that are separately charged to, and paid by, the investment product, and implicit costs that are included within the price at which the transaction takes place. The greatest challenge around calculating transaction costs is defining how to calculate implicit costs.[15] In particular, implicit transaction costs need to be defined clearly so that all parties calculate them in the same way. While it is clear that there is no perfect solution to calculating transaction costs in a standardised way, we believe that the methodology described below provides a simple and broadly accurate approach, which compares favourably to the alternative options.

Proposed approach

3.3 Our proposed approach is to require the disclosure of transaction costs based on a comparison of actual prices with the value of the asset immediately before the order to transact entered the market. This concept is the basis of most models of transaction cost analysis, and only needs two pieces of basic information for each transaction:

- The actual execution price (which should be a matter of record in an accounting system).
- The time an order enters the market (which should be captured by an order management system, and which it is a requirement of the Markets in Financial Instruments Directive (MiFID) to record[16]). This time can then be used to identify the mid-market price of the asset, called the 'arrival price'; this can then be compared to the execution price.

The approach is sometimes referred to as the slippage cost and is shown on page 13.

15 A discussion of implicit costs was contained in Chapter 3 of the Call for Evidence (see note 7).
16 Regulation EC 1287/2006, Article 8(2).

Figure 1: Slippage cost methodology

3.4 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. Where intraday market prices are not easily available, we propose 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.

3.5 In setting out an approach to calculate transaction costs, we found it necessary to come to a view on what constitutes a cost. We found from the Call for Evidence that there are different views on this topic.

3.6 The proposed approach works on the basis that, when a transaction takes place, there is typically a loss of value to the party that is undertaking the transaction. This is the difference between the price that is actually achieved and the value of the asset. This loss of value is the implicit cost of the transaction.

3.7 Some respondents to the Call for Evidence argued that a cost could only exist if a specific party could be seen to benefit from it. The alternative view was that, from the consumer's perspective, a loss of value is a cost, irrespective of whether a specific party is benefitting from it.

3.8 Some respondents also argued that costs should only be disclosed if they are under the manager's control. Again, our proposed approach takes a different view, based on the arguments of others that being able to control the level of a cost does not change the fact that it is a cost. For example, transaction taxes are a cost to the consumer of undertaking a transaction, but they are not normally within the control of the manager.

3.9 One significant advantage of treating transaction costs in this way is that it is not necessary to break down implicit transaction costs into other elements. Asset managers who want to increase the efficiency of transactions may prefer to analyse the various components that make up the transaction cost, but it is not necessary to do so to come up with a cost that could be disclosed.

3.10 From a practical perspective, this approach requires data that are widely available for most assets and can be independently audited. There is no need to engage in complicated calculations or to make estimates. If intraday or opening prices are not available, firms may use previous closing prices, which are widely available for securities and derivatives, not least because assets need to be regularly valued.

3.11 While the methodology was originally developed to analyse the costs for transactions in equities, the principle can be applied across different asset classes, and can be used as the basis for a methodology to calculate costs in any asset, whether liquid or illiquid. In Chapter 4, we explore specific situations, within this broad approach, that may raise questions.

3.12 Based on feedback to the Call for Evidence, we understand that there are a number of commercial providers who are able to carry out this kind of analysis. We also understand that it would be possible for a firm to build their own system to calculate transaction costs in line with our proposed methodology.

Other calculation issues

Removing the impact of unrelated flows

3.13 Respondents to the Call for Evidence highlighted the need to allow governance bodies to see the underlying transaction costs within a portfolio, stripping out the costs that relate to money flowing in and out. We are therefore proposing rules to ensure that the impact of anti-dilution mechanisms is taken into account when calculating transaction costs.

3.14 For a portfolio of assets with no flows, we think it is reasonable to assume that all transactions reflect the cost of managing the portfolio. However, where money flows into or out of a portfolio, the manager will need to undertake transactions to meet those flows. Funds use mechanisms called 'anti-dilution' to pass the transaction costs associated with these flows to those putting money in or taking it out. The underlying transaction costs of a portfolio can be calculated by removing the benefit the portfolio receives from anti-dilution mechanisms. The intention of the rules is to remove the benefit of whatever anti-dilution mechanism is used, so that the underlying costs can be disclosed.

Calculating the costs associated with securities lending

3.15 The definition of transaction costs that we set out in the Call for Evidence includes costs for lending and borrowing investments. We understand that the market convention is for lending agents to take a share of securities lending revenue agreed with the provider or governance body. As the stock lending revenue comes from the scheme's assets, we consider that reductions in the full revenue attributable to the loan should be accounted and reported as a cost.

Negative costs

3.16 It has been noted by some commentators that it is mathematically possible, when calculating transaction costs using this methodology, for costs to be negative. This may be because the transaction costs are so low that, within a margin of error, they are slightly negative, or it may be a fair reflection of the trading and/or investment strategy.

Alternative approaches considered

3.17 There is an established industry which calculates and analyses transaction costs. We considered whether the various alternative approaches to analysing transaction costs used by this industry would be appropriate for disclosure to pension governance bodies.

3.18 In reviewing alternative approaches, we were aware that the purpose of this analysis is primarily to monitor and review the transactions that asset managers are responsible for. This is both from a commercial perspective, to ensure that transactions are being done efficiently and for appropriate cost, and from a regulatory perspective, to monitor best execution.

3.19 Clients of transaction cost analysis firms tend to have their own requirements for the way they want to see transaction costs calculated. For this reason, it appears that the market has developed in a heterogeneous manner and there is no single standardised way in which transaction costs are analysed.

Volume-weighted average price (VWAP)

3.20 There are a number of different approaches to calculating implicit transaction costs. However, they all involve one of two primary methodologies. One involves comparing the transaction price with the published trades in a security (typically by calculating the VWAP). The other involves comparing the transaction price with the valuation of the security, as our proposed approach does.

3.21 In the past, the VWAP methodology has been very popular in the asset management industry as a way of assessing trading performance. However, from the Call for Evidence we confirmed that market practitioners now consider it an inferior approach, and it has a number of drawbacks that we consider mean that it is not the best option on which to base a standardised disclosure.

- It can only be applied in more liquid markets, where the transaction itself is not a material part of all the transactions.
- It is perceived as being more open to gaming, and transaction cost analysts do not see it as a reliable measure of trading performance, particularly when used without other approaches.

Spread

3.22 Some firms advocate using reported spreads to assess transaction costs. From the Call for Evidence, we found that this is likely to pose significant challenges, not least around definition. Defining in theory what constitutes the spread on an instrument is challenging. Spread can vary over time, and it can often be hypothetical in nature (i.e. a price to buy might be clear and available to transact, but the simultaneous price to sell might merely be indicative). Spread also varies with size, so that it is not independent of the person transacting.

3.23 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 precisely how spread is calculated. This would create a lack of confidence that the information from one provider can be compared with another, and could lead to competition between providers to minimise the spread that they report, instead of them competing to minimise transaction costs.

3.24 It might be possible to provide detailed regulatory guidance that could set out rules to calculate spread, or to publish a table of data that sets out standard spreads in particular assets. We consider that this would be likely to be too inflexible, and would fail to create the appropriate incentives as firms would be reporting a generic spread rather than the spread that they have actually incurred.

3.25 One way of addressing the challenges of defining spread is to establish an 'effective spread' when a transaction takes place. This involves establishing the 'actual' spread that is paid, based on knowledge of the actual transaction price and the previous mid price. This approach is most attractive in markets where execution is generally in single fills. We believe our proposed approach is very close, if not identical, to a calculation of the effective spread.

Market impact

3.26 Many respondents argued that market impact is a real cost of trading. Expert respondents generally agreed that spread by itself cannot be viewed as the whole cost of transacting. In particular, they noted that institutional investors normally trade in order sizes that are larger than the typical volume that can be dealt at the quoted spread. Respondents argued that when a large order takes time to complete and is completed in multiple individual fills, the buyer or seller generally moves the market against themselves, incurring costs.

3.27 Since a large proportion of equity orders are transacted in this way, the transaction cost analysis industry analyses market impact for equity orders. However, as noted above, this industry has developed with few common standards, and a wide range of definitions of precisely what constitutes market impact.

3.28 Our view is that the need to define and measure precisely what constitutes market impact is likely to be most important when analysing individual orders. It is possible to adjust for the impact of market movements under our proposed approach. This could be done by adjusting the arrival price by the movement in the underlying market (using a market index). We consider that such an approach would create complexity without material benefit. When analysing a large number of orders, the component of market impact that relates to market fluctuations should tend towards zero. Where it does not, this represents a cost that is the consequence of the investment or trading strategy.

3.29 For this reason, we are not proposing to establish a definition of market impact in our rules. However, we consider that the methodology proposed will capture the cost of market impact.

Delay costs and opportunity costs

3.30 Delay costs are generally defined as the impact from not executing an order on the day that it is raised. This impact from delaying execution could potentially be converted into an opportunity cost if the decision-maker decides not to transact at all. Few respondents argued for us to include delay costs, and all respondents said that an opportunity cost relating to a trade which did not take place could not be disclosed as a transaction cost.

3.31 We set out a methodology that excludes the impact of delaying execution by resetting the arrival price to the opening price on the day of the transaction (or the previous close, where an opening price is not available).

3.32 While delaying execution of a transaction may lead to a worse outcome for investors, this will be reflected in lower investment performance. Most funds that invest in securities are priced daily. As such, it appears reasonable to count factors that affect the day-to-day performance as investment performance, while costs that arise on the day that a transaction takes place are transaction costs. Delaying execution of a trade may be more influenced by market movements unrelated to the order. An order could be transmitted several days or weeks prior to execution. In this instance, it may not be reasonable to assume that movement of the security during that time is a transaction cost.

3.33 For these reasons, we do not believe that the argument set out in 3.28 around market impact necessarily holds for the impact of delaying execution. If governance bodies wish to understand information about the impact of delay, we understand from transaction cost experts that it should be relatively straightforward for asset managers to calculate this.

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

4.
Issues specific to asset classes

Introduction

4.1 This chapter covers some issues that have been raised around calculating transaction costs for specific asset classes. As noted in Chapter 3, we consider that the general principle for the calculation of costs should be widely applicable. We set out in this chapter certain areas where we considered whether we need to set out a more detailed approach to ensure consistency of treatment. In some areas we propose additional rules or guidance, while in other areas we consider that this is not necessary.

Equity market issues

4.2 Trading in the equity market has changed significantly over the past few years. The increasing use of electronic and automated trading means transactions are conducted very differently from the way they used to be even ten years ago. Our proposed rules must be resilient to further changes in practices. We believe we have created a regime that allows for the reporting of transaction costs that have been incurred, without creating incentives on asset managers to undertake transactions in a particular way. However, there are some areas where further guidance might ensure greater consistency, which we discuss below.

Auctions

4.3 Most equity trades occur during continuous trading. However, some trades are agreed by auction (for example, opening or closing auctions) or other forms of matched crossing. Some orders are placed into an auction, for example to achieve a market closing price. It does not seem reasonable to assume that such an order does not incur transaction costs. An imbalance of buys or sells during an auction has in the past led to significant temporary price moves. We propose that it would be appropriate to consider the previous mid price immediately prior to the auction as the appropriate arrival price when an order is transmitted to be entered into an auction.

Time of order transmission

4.4 When an instruction is given to place an order into the market at a specific time (for example, at the close of business), the price at the time the order is transmitted to an executing broker may not be a fair benchmark. Without additional guidance, the general principle would imply that firms would use the time the order was transmitted to identify the arrival price, rather than the time at which the order was instructed to be executed. We think that allowing flexibility to amend the order time will create complexity without much benefit. Therefore, we are proposing that the time the order was transmitted should be used to calculate the arrival price.

4.5 When an order is transmitted to a broker outside trading hours, there will not be a clear current price. In this situation, we propose that the subsequent opening price should be used.

Bond market issues

4.6 We are aware that many bonds do not trade on a frequent basis. However, market data providers maintain prices for bonds on a daily basis that show the current valuation. When viewed at portfolio level, we consider these prices to be a fair assessment of the current valuation and, without more detailed intraday prices, are a fair basis for an arrival price to calculate transaction costs. We are aware that market transparency initiatives under the Markets in Financial Instruments Directive / Regulation (MiFID/R) may lead to a greater availability of intraday prices for bonds, but that currently there is less transparency. We consider that our rules, while sufficient for the current level of market transparency, will allow flexibility for such market developments.

Currency market issues

4.7 Foreign exchange transactions are often ancillary to deals in other assets. We are aware that there are market practices where asset managers have an agreement with a bank or broker to process foreign exchange orders in a systematic way at a point in time. Evidence from enforcement cases in foreign exchange market manipulation[17] demonstrates that there are situations where transaction costs may be incurred during foreign exchange deals which are not transparent. We want to ensure full, transparent reporting of the transaction costs of foreign exchange.

4.8 To achieve this, we propose that a consolidated foreign exchange rate should be used that reflects the rate available in the market at the time of the order. This should be the case irrespective of whether there is an agreement in place with a single counterparty to undertake all foreign exchange transactions. This should make clear to governance bodies the costs that such arrangements are incurring.

Derivatives issues

4.9 As raised in the Call for Evidence, it would clearly be unworkable and undesirable if the costs associated with derivatives were not included within the disclosure. For this reason, we are setting out some general principles on how to capture the costs associated with derivatives.

Price transparency

4.10 Many derivatives, such as futures in major indices, are publicly traded on transparent markets. In these situations, we believe it is appropriate to use an approach that captures the transaction costs relative to the transparent price, using the general principle. This would mean using, as the arrival price, the price of the derivative at the point the order is transmitted to a broker. The transaction cost would be the value of the exposure to the underlying asset that the transaction has obtained at the actual transaction price, compared to the value of exposure that would have been obtained at the arrival price.

4.11 Other derivatives, in particular bespoke over-the-counter derivatives, may have no direct price transparency in the derivative itself. Here we see it as reasonable to calculate transaction costs using the costs of transacting in the underlying asset(s). This would mean using the price of the

17 For example, FCA fines of Barclays (www.fca.org.uk/news/fca-fines-barclays-for-forex-failings) / five banks (www.fca.org.uk/news/fca-fines-five-banks-for-fx-failings) / US DoJ settlement with BNY Mellon (www.justice.gov/usao-sdny/pr/manhattan-us-attorney-and-new-york-state-attorney-general-announce-714-million-proposed).

underlying asset(s) as the arrival price, appropriately weighted if the derivative relates to more than one underlying asset, and adjusted for any costs in the derivative.

4.12 We understand that the calculation of transaction costs using the general principle above should be straightforward for many types of derivatives. However, there may be situations that we have not considered that would create additional complexity, and we welcome feedback on these.

Non-linear derivatives

4.13 We are proposing additional guidance in relation to non-linear derivatives. Some derivatives are linear (i.e. their prices move up and down directly in line with movements in the underlying asset) and we can reasonably assume that, where the transaction costs for dealing in the derivative itself are difficult to calculate, they are essentially the same as the costs associated with dealing in the underlying asset.

4.14 However, other derivatives, such as options, are non-linear. The transaction costs of transacting in an option may be materially different from those of dealing in the underlying security. We therefore need to set out a different approach to assessing the costs associated with dealing in non-linear derivatives.

4.15 Using the general principle for transaction cost disclosure, the value of the option needs to be assessed at the point when the order is transmitted to a broker. We propose that, in the case of an option, this would be the fair value. This would mean assessing the fair value of the option before trading. There may be a market price in the option. However, as this market price will be linked to the price of the underlying in a non-linear way, and since market prices in options may not be updated as fast as prices of underlying assets, we think that it is appropriate to use a fair value price, rather than a market price, as the arrival price. We will not define how firms should calculate the fair value price, but consider that normal market conventions for calculating such a price should be appropriate.

Illiquid assets

4.16 DC schemes also invest in some illiquid assets, particularly property. As the market develops, there may be more types of assets DC schemes can invest in; as such, the rules set out how we would see the approach working for illiquid assets.

4.17 Using the general principle, to establish an arrival price involves assessing the value of the illiquid asset prior to trading in it. If the asset is currently owned by the scheme, the prior valuation should provide an indication of this value. However, illiquid assets may not always be valued on a frequent basis, and this valuation may need to be adjusted for known market movements. Alternatively, when the owner of an illiquid asset intends to sell, they may have the asset independently valued to ensure that they pitch the sale at the right price. Here, it would be appropriate to consider this independent valuation as the fair value prior to transacting.

4.18 To ensure that the true costs of transactions in illiquid assets are disclosed, it is important to ensure that all explicit and implicit transaction costs are included. There are often significant explicit costs for transactions in illiquid assets. Any appraisal of fair value prior to sale must exclude the explicit costs of sale, to ensure that these are disclosed as transaction costs.

4.19 When an illiquid asset is bought for the first time, there may not be a clear prior valuation available. In these circumstances, the buyer will need to make an assessment of fair value, based

on reasonable, comparable information. As with a sale, any explicit costs must be disclosed as transaction costs.

4.20 In carrying out this exercise, our view is it is unreasonable to assume that the fair value of the asset being purchased is materially higher than the purchase price.

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

5. Proposed approach to amalgamating transaction costs at arrangement level

Introduction

5.1 The transaction costs we have described for investment funds will need to be amalgamated at an overall level of each arrangement (as described in chapter 2). Operators who provide arrangements investing in multiple underlying funds will need to capture both the transaction costs of those underlying funds and the costs of transactions they make between funds. This chapter sets out how we expect this to work.

Calculation of transaction costs at arrangement level

5.2 Many respondents to the Call for Evidence agreed that transaction costs should be disclosed to governance bodies at the level of the individual arrangements available to members, even where these are made up of underlying funds which themselves incur transaction costs.

5.3 When an arrangement transacts in units in a fund, it will do so at the price of those units in the fund. When an arrangement (or a multi-asset fund in which an arrangement invests) transacts in a fund, it may incur transaction costs, either through paying an anti-dilution levy or by dealing at a price that is different from the mid price.

5.4 Any explicit transaction costs like this should be simple to calculate. Implicit transaction costs incurred in this way should be calculated as the difference between the actual dealing price and the fair value mid price, multiplied by the number of units transacted. Where a fund deals at a swinging single price, it can incur negative transaction costs, if the swung price reflects a more favourable price than the mid price.

Amalgamation of transaction costs at arrangement level

5.5 If an arrangement holds an investment fund for the entire reporting period, it will incur its share of all of the transaction costs incurred by the fund over the period. This will be simple to report. However, there may be many circumstances where an arrangement does not hold a fund for a full reporting period.

5.6 In this situation, the arrangement needs to include an appropriate portion of the underlying fund's transaction costs. It may be difficult to provide a precise calculation, as the scheme would have to ask the provider of the underlying fund for information about transaction costs for

every period in which its holding changed. Technological developments may make it possible for this type of information to be routinely calculated, but we propose allowing the use of a pro rata approach where the scheme can assume that transaction costs happen evenly throughout the year, and the transaction costs for the underlying fund can be included on a pro rata basis, according to the amount of time that the arrangement owns the fund.

5.7 Similarly, information about the transaction costs of underlying funds may not be available at the period end of the scheme. Here also, we propose allowing the use of a pro rata method to estimate the scheme's transaction costs. If the transaction costs are not available for the entire period, we propose that the costs from the previous known period are used to avoid delays until more accurate information is available.

Look through of costs

5.8 To ensure consistency when amalgamating and presenting information, costs from vehicles that are not the primary investment vehicle need to be taken into account. For this reason, we consider that the rules should require a comprehensive coverage of the costs of underlying investment schemes. We propose that any disclosure of transaction costs should look through to, and consolidate, the transaction costs of underlying investment vehicles.

5.9 However, in setting out this requirement, we know there will be situations where arrangements invest, for example, in an index-tracking strategy and hold small amounts of securities, such as investment companies, that themselves incur transaction costs. In guidance we set out our expectation that a firm making a request should consider the materiality of the information it is seeking to the overall costs and charges of each arrangement.

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?

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?

6.
Presentation of transaction costs

Introduction

6.1 How transaction costs are presented is a key aspect of their disclosure. This chapter explains how we see transaction costs being presented and explains that we are not proposing to set out detailed rules around presentation.

Reporting of costs to IGCs and trustees

6.2 IGCs and trustees need to see information about the transaction costs for their scheme(s) to enable them to fulfil their obligations. Both IGCs and trustees are required to assess whether the transaction costs represent value for money, and to do so on an annual basis. We are aware of a number of initiatives to standardise the presentation of costs, and we do not consider that we need to make rules to specify precisely how information should be presented to governance bodies.

Breakdown of costs

6.3 The methodology for the calculation of transaction costs described in Chapter 3 provides a comprehensive figure for the transaction costs incurred. However, it does not provide a breakdown of specific elements of cost without further analysis. Some elements of cost are more clearly identifiable than others. Explicit costs such as brokerage and transaction taxes (e.g. stamp duty) are already reported to trustees and should be available for IGCs to review.[18] There are also other costs that are separately identifiable, such as the costs associated with securities lending. Since the costs of securities lending are different from the costs for buying or selling assets, we propose that these costs should be reported alongside, but separately from, the costs for buying and selling assets.

6.4 We propose that asset managers should provide transaction costs on request, as a total cost with a breakdown into categories of identifiable cost. We propose, in guidance, that these should include taxes, explicit fees and charges, and securities lending costs.

18 Via the Level Two disclosures of the Investment Association's Pension Fund Disclosure Code.

Contextual information

6.5 The Pensions Act 2014 expects contextual information may be provided alongside transaction costs. There are a number of pieces of information that could be of value if presented like this. For example, information about the return and risk of the fund, and the administration charges involved, should enable transaction costs to be seen in the context of the net return being generated. Respondents were strongly in favour of transaction costs being presented in context.

6.6 Because of governance bodies' differing needs, and our desire to avoid unnecessary duplication of reporting, we propose a rule that other relevant information should be presented, rather than requiring specific information. We set out in guidance examples of the types of contextual information that might be provided, if this information is relevant and available.

6.7 The Pensions Act 2014 will require the FCA and DWP to make rules for disclosing and publishing administration charges alongside transaction costs. For this reason, and to enable governance bodies to meet their obligations in this area, we propose rules requiring disclosure of these costs to governance bodies.

Inability to obtain transaction costs

6.8 There may also be situations where it is not possible for the lead provider or the governance body to obtain all of a pension scheme's transaction costs. If an investment manager is not FCA-regulated, these rules do not create a direct obligation on them to calculate information about transaction costs. Guidance on how the FCA expects IGCs to address this issue is provided in the handbook.[19]

6.9 It may be possible for the governance body or lead provider to obtain this information, such as by contractually requiring disclosure of transaction costs through the investment management agreement. If exposure comes from a fund, the governance body could ask the fund manager to provide this information.

6.10 If those from whom transaction cost information has been requested are not able to provide it for all the assets in a scheme, we propose that they disclose this clearly to the governance body with an explanation of why this has not been possible. We also propose that they disclose the percentage of assets for which they have not obtained transaction costs, and how those assets are invested. This will help the governance body in meeting its obligations around assessing transaction costs.

Frequency of reporting

6.11 We are not proposing to mandate a specific frequency for reporting transaction costs to governance bodies. IGCs are required to produce an annual report, and trustees an annual Chair's Statement, both of which must consider value for money. As such, transaction costs will be considered by governance bodies at least once a year. It makes sense to include information about transaction costs within the standard reporting cycle of the provider or investment manager to the governance body, and we do not propose going beyond existing requirements in this area.

19 COBS 19.5.6G(4): Where an IGC is unable to obtain from a firm, and ultimately from any other person providing relevant services, the information it requires … the IGC should explain in the annual report why it has been unable to obtain the information and how it will take steps to be granted access to that information in the future.

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?

Annex 1
List of questions

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?

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

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

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?

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?

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?

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

Annex 2
Cost benefit analysis

1. The Financial Services and Markets Act 2000 (FSMA), as amended by the Financial Services Act (2012), requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs together with an analysis of the benefits' that will arise if the proposed rules are made. It also requires us to quantify these costs and benefits, unless we cannot reasonably estimate them or it is not reasonably practical for us to produce an estimate.

Market failure analysis

2. In its 2013 market study report[20], the OFT concluded that the market for DC workplace pensions is not working well and that competition alone cannot be relied on to drive value for money for all scheme members. The buyer side of the market was one of the weakest that the OFT had analysed in recent years.

3. As a consequence, the operators of workplace pension schemes (both trust and contract based) are not under sufficient competitive pressure to ensure that the costs and charges to scheme members provide value for money.

4. Transaction costs have a number of issues that contribute to buyer-side weakness and market failure, which we consider in more detail below. In particular, there is information asymmetry between clients of investment management firms and the firms themselves.

Information asymmetry

5. To evaluate whether costs that are incurred on their behalf represent value for money, clients of investment management firms need information about those costs. Some information about transaction costs is disclosed to investment management firms' clients, under the Investment Association's Pension Fund Disclosure Code.[21] Level One disclosure, meeting requirements under MiFID, requires disclosure of how dealing efficiency is monitored, while Level Two disclosure requires the disclosure of brokerage commissions paid to counterparties. This information should be available to a pension scheme's governance body, but is not made available to scheme members. The information is not made public, and a research paper into this topic[22] identified that it is very difficult to obtain this information because investment managers require clients to sign confidentiality agreements. The paper notes that UK public pension funds strongly resisted public disclosure of the information until they were forced to do so by a ruling under the Freedom of Information Act.

20 See note 6.

21 www.theinvestmentassociation.org/assets/files/industry-guidance/20070901pfdc3.pdf.

22 Abrahamson, Mark, Jenkinson, Tim and Sousa, Miguel, Does Transparency Overcome Conflicts of Interest? Evidence from Investment Managers and Their Brokers (March 1, 2012). Available at SSRN: ssrn.com/abstract=1364391 or http://dx.doi.org/10.2139/ssrn.1364391.

6. Even where governance bodies have information, they may be unable to assess how far transaction costs represent value for money. This is because they have incomplete information about the transaction costs they pay and have limited access to comparable information. The lack of wider information about the transaction costs of comparable providers also makes it difficult for governance bodies to act on the information by changing provider.

7. However, this research paper also points out that dealing commission rates have come down since disclosure has become common. Yet the authors note a significant rise in dealing volumes, leading to higher aggregate commission payments, and hence higher costs.

Cost benefit analysis

8. We propose introducing a standard form of disclosure of transaction costs for governance bodies and to require those who have information necessary to calculate transaction costs to do so and to pass it on to those who need it.

9. When assessing the costs and benefits of our proposed intervention, we consider these against the case where no intervention takes place (the baseline). There is currently an obligation under COBS 19.5.5R 2(e) for IGCs to assess the value for money of costs, including transaction costs, and under COBS 19.5.8G (5) for providers to make best endeavours to provide information about these. There is an equivalent provision in DWP rules for trustees to assess the extent to which transaction costs represent good value for members.[23]

10. If we do not make these rules, providers and trustees will need to ask asset managers to provide transaction costs according to whatever definition they see fit. The lack of a standard definition of transaction costs has been cited as a root cause of a lack of a standard way of disclosing them. Based on feedback to the Call for Evidence, we believe that, if we do not define transaction costs in a standard way, there will continue to be a lack of coordination among industry participants and they will not develop a standard approach to disclosing transaction costs.

11. The consequences of a lack of a standardised approach to calculating transaction costs are that: requests for information about transaction costs will be ad hoc and more expensive for firms to deal with; governance bodies will not have confidence that the information that they are reviewing is consistent with other disclosures of transaction costs, and hence may feel that it is not possible to assess whether the transaction costs incurred on their behalf represent value for money; and this may lead to less effective pressure on investment managers to deliver value for money from transaction costs.

Costs and benefits from standardisation

Summary

12. We estimate that setting out a standard way in which to disclose transaction cost information will lead to net savings to industry of approximately £24m over the next five years.

Current situation

13. Current rules in COBS 19.5 require trustees and IGCs to obtain (among other things) transaction cost information to assess on an annual basis whether these costs represent value for money. Without a standardised form of disclosure, requests for information about transaction costs occur on an ad hoc basis, whenever the governance body is reviewing this material, to whatever specification they feel appropriate for their needs.

23 The Occupational Pension Schemes (Charges and Governance) Regulations 2015 (SI2015/879).

14. There are three different types of arrangement that we consider:

- trustees of a stand-alone scheme
- trustees of a mastertrust, and
- IGCs of a contract-based pension provider

Table 1: Numbers of pension schemes

Type	Number of schemes	Evidence
Standalone schemes	6,700	The Pensions Regulator (TPR) DC returns of schemes with over 12 members (less mastertrusts) plus TPR/DWP estimates of number of micro-trusts subject to new governance requirements
Mastertrusts	50	TPR DC returns
Contract-based schemes	30	FCA estimates

15. We need to make a number of assumptions to assess the benefits of standardising transaction cost disclosure:

- Each standalone scheme uses a single insurer/asset manager. Since there are many schemes that use more than one provider, this is almost certainly an underestimate. We assume that each scheme offers around 10 investment options.
- Each mastertrust offers a wide range of products, in a similar way to a contract-based scheme.
- A contract-based scheme offers around 150–250 different investment options.

16. We estimate the annual cost to a firm responding to an ad hoc query from a standalone scheme client to be around £1,000. We asked firms to provide us with information on this. One firm estimated it at £6,000, while others did not provide any specific information. We do not consider that a single response constitutes adequate evidence, so we have also compared the responses that firms gave to the cost of responding to our information request. This was typically around £1,000. We believe this should be a reasonable estimate of the cost of responding to an ad hoc request for information.

17. We assume that an ad hoc request from a mastertrust or an IGC would be materially more expensive. Given the additional number of funds, we propose multiplying the cost by 20.

18. This leads to a total annual current cost to the industry from the need to provide transaction cost information in response to ad hoc queries under existing rules of £8.3m.[24] Rules standardising disclosure of transaction costs should eliminate the need for governance bodies to make ad hoc requests.

24 £6.7m for the 6,700 standalone trusts, and £1.6m for the 80 mastertrusts and contract-based schemes.

Costs of a standardised solution

19. We estimate the costs of a standardised solution in two parts:

- costs of calculating transaction costs, and
- costs of reporting transaction costs to clients

Costs of calculating transaction costs

20. Our proposed rules will require asset managers to calculate the transaction costs they are incurring on relevant portfolios. Most of the asset managers who gave us information currently use either third-party or in-house systems to calculate transaction costs. Information given to us from third-party providers of transaction cost analysis implies that their systems will be capable of producing reports on our proposed standardised basis with limited amendment.

21. In response to our information requests, around half of the top 60 UK asset managers report that they manage assets for DC pension schemes. Of these, the top 10 asset managers manage around 90% of all DC assets. Our understanding is that few alternative investment managers manage DC assets, so we assume that the vast majority of firms in this market also manage retail funds. The Investment Association lists 90 firms as managing retail funds as at September 2015. On this basis, we base our cost estimate on the assumption that, at most, 50 asset managers manage money that will put them in scope of the rules in this consultation.

22. Based on information that we have received and our understanding of the market, we assume that, of these 50 firms, 40 are buying systems from third-party providers, five have in-house systems, and five currently have no transaction cost analysis capability.

23. Based on information we have received from transaction cost analysis firms and asset management firms, we estimate the calculation cost for a firm which is currently buying a system from a third-party provider will be around £10,000 pa, for a firm with an in-house system, a one-off cost of £25,000, and a firm with no system currently will incur a cost of £75,000 pa.

24. On this basis, we estimate that the market will incur one-off costs of £125k and £775k per annum on an ongoing basis.

25. Firms already disclose information about certain explicit costs via the Pension Fund Disclosure Code. In response to information requests, most firms stated that there would be no marginal cost to providing this information in any standardised disclosure of transaction costs, so we do not assume additional costs for firms disclosing this breakdown of information.

Costs of reporting transaction costs to clients

26. Based on previous estimates, we believe that there are 21 insurance firms currently operating in the workplace pensions market, with around another 10 not currently active but with legacy schemes. We assume there are about 30 providers who will need to produce these reports.

27. Based on responses to FCA information requests, we estimate that reporting costs will be around £150,000 per independent asset management firm and £250,000 per insurance firm. We assume that around ten insurers also have asset management subsidiaries and that the reporting costs will be shared across these businesses. This gives an estimate of one-off costs associated with reporting of £13.5m.

Benefits

Nature of benefits

28. We expect greater disclosure of transaction costs to lead to greater scrutiny of whether transaction costs represent value for money for scheme members. This should lead to governance bodies challenging whether some investment strategies deliver a sufficiently good risk-adjusted investment return for the transaction costs involved.

29. Improved disclosure of transaction costs should also encourage greater confidence in pension investment. This, in turn, could lead to greater participation (lower opt-out rates from auto-enrolment) and higher contributions. In the event that the market grows more rapidly as a result, this will lead to greater revenues for firms.

30. We also expect firms to benefit from a standardised definition of transaction costs. Firms will be able to give clients the regulatory standard disclosure reports on transaction costs, which will significantly reduce the need for ad hoc requests for information about transaction costs.

Benefits to consumers

31. In its market study on the DC workplace pension market, the OFT quoted estimates by Spence Johnson of the total size of the workplace DC market in 2013 of approximately £276bn.[25] Some commentators estimate that auto-enrolment is leading to market growth of around 10% per annum.[26]

32. A paper by the Defined Contribution Investment Forum in 2011 noted that larger DC schemes had around 70% of their assets managed passively.[27] While their estimate is that smaller schemes invest less in passive management, we use a breakdown of 70% passive, 30% active as the conservative basis for our assessment of the potential benefits of improved transaction cost management. Based on our understanding of the market, and typical levels of portfolio turnover previously reported, we assume that an actively managed fund turns over its portfolio roughly once (i.e. 100% turnover) per annum (buys plus sells) and a passively managed portfolio turns its portfolio over roughly 10% per annum (buys plus sells).

33. On the basis that these rules come into force in 2017, and assuming a more conservative market growth rate of 5%, the market size would be £320bn in the first year, rising to £390bn by year 5. On the basis above, for illustrative purposes, each basis point reduction in active trading costs would provide a benefit to consumers of around £11m per annum and each basis point reduction in passive trading costs would lead to a benefit to consumers of roughly £2m per annum.

Benefits to firms

34. As per the analysis in paragraphs 13–18, we believe that a standardised definition of transaction costs will reduce firm expenses by approximately £8.3m per annum.

35. Greater confidence in the pensions system may lead to an increased growth rate in the market for pension savings. Using the estimates of market size and growth set out in the section on benefits to consumers, for the purpose of illustration an increase in the market growth rate of an additional 0.1% will lead to a benefit to the industry of around £3.5m in additional revenue per annum (based on an average 0.5% fee).

25 OFT market study p.61.

26 For example Spence Johnson estimated in 2015 that the market would grow at 11% per annum from 2016 to 2024. Mintel estimated in June 2015 that new insurer-administered premiums are growing at c.10% per annum.

27 The prodigious use of passive funds in UK DC (DCIF, Nov 2011) www.dcif.co.uk/publications/download/1/The-prodigious-use-of-passive-funds-in-UK-DC.

Table 2: Summary of costs and benefits of proposals

	Estimated direct costs and benefits	
	One-off	Ongoing (per annum)
Firm costs (£m)	13.6	0.8
Firm benefits (£m)		8.3

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

Annex 3
Feedback from the Call for Evidence on Transaction Costs Disclosure (March 2015)

1. In the Call for Evidence, we asked a number of questions. This annex provides a summary of the responses we received. The Call for Evidence was conducted jointly with the DWP. We have incorporated much of the feedback into this CP and used the information provided to form the views contained in this CP. Not all of the issues raised within the Call for Evidence are relevant to the current consultation. The other issues will be considered by the FCA and DWP in any subsequent rules or regulations around information about transaction costs to be disclosed to pension scheme members.

2. We received 42 written responses to the Call for Evidence, from asset managers, pension schemes, pension providers, service providers to the industry and consumer representatives.

Chapter 2

3. **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?

- The majority of those who responded to this question were in favour of applying the requirements to defined benefit (DB) schemes as well as DC, highlighting that many DB schemes also have DC sections.
- The majority of those who said that the requirements should only apply to DC schemes considered it appropriate to widen the scope at a later date.

Chapter 3

4. We asked a number of questions about how to calculate transaction costs. The section below sets out the consolidated feedback from these.

5. **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?

6. **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 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?

7. **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?

8. **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?

   - The overwhelming majority of respondents considered that spreads are measurable and should be included in transaction cost reporting. There was a more mixed response to the question of inclusion of market impact, although the most technical respondents argued that market impact ought to be captured, despite the technical challenges of doing so. Transaction cost analysis firms suggested that the technical issues could be addressed. Almost all respondents did not believe that delay costs or opportunity costs are transaction costs, or argued that there is little merit in them being reported.

   - A number of respondents stressed the complexity and technical nature of transaction cost analysis: in particular, the difficulty of measuring implicit costs and the requirement for a high level of technical knowledge to interpret data.

   - Some considered that the extra burden might be disproportionate to the benefits of disclosure.

Chapter 4

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

   - The majority of respondents favoured reporting at fund level. A minority said it would be possible to report at asset level, but most suggested reporting at this level would be too complex. Other comments stressed the need to focus on net returns and to develop a consistent standardised approach.

10. **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?

    - This question created a mixed response. A number of respondents favoured including entry and exit fees. Respondents agreed there should be an explanation of the pricing basis, but there was less agreement on reporting the actual cost.

    - Some respondents suggested trying to capture and report a net average swing at a scheme level, and others suggested costs at product level should be reported separately.

11. **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?

    - Most respondents favoured a requirement to look through to underlying assets, while accepting the challenges in achieving this. There were some caveats, such as the need to ensure proportionality and the potential need to include modelled costs.

12. **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?

    - Most respondents favoured including derivatives in disclosure of transaction costs. A few considered that derivative costs should be disclosed separately.

13. **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?

    - Most respondents favoured a standardised approach using actual costs if they are available and standardised modelled costs if not, with modelled costs potentially appropriate for illiquid asset classes. Of those who expressed a view, there was a roughly even split between those favouring a principle-based approach and those favouring prescription.

14. **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?

    - An overwhelming majority of respondents was in favour of reporting portfolio turnover rate (PTR). Some suggested that this should not be reported to members due to the possibility of misinterpretation. Others suggested the need to include narrative to explain reasons for turnover.

15. **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?

    - The majority of respondents felt that governance bodies would benefit from receiving information about risk and return along with transaction costs information. Some suggested that there was no need to formally require this information, as it was already readily available and known to governance bodies. Some stressed that transaction costs must be reported in the context of returns.

    - A few respondents did not feel such information should be included, although most of these respondents pointed out that it was already available anyway.

16. **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?

    - The majority of respondents were in favour of some form of benchmarking to help comparison. A number pointed out that there are some risks, for example the risk of herd behaviour and of driving asset managers' behaviour simply to compare well against the benchmark.

    - Some suggested standardised comparable data will be sufficient or that DIY benchmarking is possible, so introducing a benchmarking model may not justify the cost of introducing it.

17. **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?

    - Most favoured reporting foreign exchange and stock lending, although some recognised practical difficulties, such as collating comparable data.

    - Some argued foreign exchange costs were transaction costs and should be reported, whereas some argued that stock lending, rather than foreign exchange, should be reported.

18. **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?

    - The majority of respondents to this question favoured a standardised approach, but a number also stressed the need to keep it simple. Some responses suggested that governance bodies would need more detailed information than members. Other suggestions were that reporting in basis points is a better way of comparing than pounds and pence, but some suggested that percentages were baffling to members and pounds and pence would be preferable. A common theme was that information must be presented in context, particularly of returns.

19. **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?

    - Responses were mixed with no real preferred view. A slightly smaller number of respondents were in favour of reporting PTRs as a predictor of future costs compared to those who felt doing so would not be useful. Of those who see PTR as useful, some felt that this information provided good context, that the information needs to be presented with caveats, and that estimates based on past turnover cannot predict the future but can give useful indications.

    - Of those who were not in favour, some suggested predictions could be misleading, are difficult to interpret, and introduce an element of guesswork. If used as a predictor, some suggested using a reasonable period of past turnover to smooth out unusually high or low periods of turnover.

20. **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?

- Potential consequences raised included driving investment managers away from certain types of investment where costs are difficult to obtain, and causing a focus on transaction costs at the expense of delivering the investment objectives. This may lead to schemes investing in low-cost funds which could produce poor member outcomes, or to passive investment strategies with lower portfolio turnover.

Chapter 5

21. **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?

- The overwhelming majority of respondents to this question agreed that duties should fall on investment managers to provide transaction cost information to trustees and IGCs. Some argued that duties should also fall on other bodies responsible for providing data, such as custodian banks. Some raised issues about investment managers based outside the UK where rules will not apply.

- A minority of respondents said duties should only be on trustees/providers to give the information, rather than on investment managers. They argued that this will inevitably motivate investment managers to also provide the information, as trustees and providers will choose those who do.

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

- The majority of respondents said members and employers should not be provided with information on transaction costs at the same level of detail as that given to trustees and IGCs. Trustees and IGCs need detailed, standardised information to make decisions based on value for money. Information to members needs to be less detailed and must be in context to avoid driving perverse behaviours, such as opting out on the basis of cost alone.

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

- Many argued that the information should be publicly available, with some suggesting that it should be included either in the Chair's Statement or in the scheme annual report, and that this could be made public. There was some limited support for publishing on a central, online repository, with one respondent arguing this could be collated by the appropriate regulator.

24. **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?

- Some respondents noted that it may be difficult for trustees and IGCs to comply unless information is made available to them. Investment managers may find it difficult to obtaining certain types of information (e.g. where funds use non-UK asset managers), and the process may be complex or costly. Using standardised models should minimise the scope for non-compliance.

- Some respondents supported third-party oversight to increase trust and validity of the process. Some argued there is already oversight via the Institute of Chartered Accountants of England and Wales assurance reporting; others argued trustees/IGCs would provide sufficient oversight.

25. **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?

- Responses varied from those who thought costs would be relatively low to those who thought costs would be considerable. The majority view was that setting up a transaction cost reporting regime will have a cost to industry, but the magnitude will depend on the process adopted and the level of detail/complexity required.

- Some argued that the benefits will outweigh the costs and others pointed out that the costs can be minimised if the UK regime is aligned with future European requirements.

Annex 4
Compatibility statement

1. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation, including an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under FSMA.

2. When consulting on new rules, the FCA is required by section 138I(2)(d) FSMA to include an explanation of why it believes making the proposed rules is (a) compatible with its general duty, under s. 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, and (b) its general duty under s. 1B(5)(a) FSMA to have regard to the regulatory principles in s. 3B FSMA. The FCA is also required by s. 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.

3. This Annex also sets out the FCA's view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (s. 1B(4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.

4. This Annex includes our assessment of the equality and diversity implications of these proposals.

5. Under the Legislative and Regulatory Reform Act 2006 (LRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRA.

The FCA's objectives and regulatory principles: Compatibility statement

6. Our proposals are primarily intended to advance our operational objective of consumer protection. Better information about transaction costs in workplace pension schemes should protect the interests of pension scheme members by enabling governance bodies to obtain value for money from those costs. In coming to this view, we have had regard to the matters in s.1C(2) of FSMA, as explained in the following paragraph.

7. We are proposing to require the disclosure of transaction costs across all different kinds of investment made by certain pension schemes. We consider that greater disclosure of transaction costs should clarify for pension scheme governance bodies the costs associated with different kinds of investment and transactions, without changing the risk of those investments or transactions. The fact that the information will be considered by pension scheme governance bodies addresses the differing degrees of expertise and experience that different consumers may have. In Chapter 3 we set out why we consider calculating the information in the proposed manner to be the most accurate and fit for purpose to meet the objective of setting a standard disclosure of transaction costs. In Chapter 6, we set out why we are proposing a broad

framework for disclosure, as opposed to making specific detailed rules on presentation, taking into account differing expectations of consumers. We consider that we have not received any information from the consumer financial education body or the ombudsman scheme that is relevant to this issue.

8. Our proposals are also relevant to our operational objective of promoting market integrity. Better oversight of the transaction costs should lead to agents acting on behalf of workplace pension schemes being better held to account. This should in turn improve the orderly operation of the financial markets.

9. We consider the proposals in this CP are compatible with our strategic objective of ensuring that the relevant markets function well, since they are designed to ensure that information about transaction costs is passed to those who have a legal duty to assess whether they represent value for money. For the purposes of the FCA's strategic objective, "relevant markets" are defined by s. 1F FSMA.

10. In preparing the proposals set out in this consultation, we have had regard to the regulatory principles set out in section 3B of FSMA.

The need to use our resources in the most efficient and economic way

11. Our proposed approach is to standardise the calculation of transaction costs. This has no ongoing cost to the FCA.

The principle that a burden or restriction should be proportionate to the benefits

12. As set out in the CBA in Annex 2, we believe that there will be a net benefit to firms from the greater efficiency of having a standardised approach to calculating transaction costs, compared to having no standards in place. We consider the proposed approach proportionate as it uses data which is widely available, and enables firms to reuse systems which they already have.

The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term

13. Our proposals support the government's policy objective of people saving more for their retirement and thereby relieving the tax burden on future generations. Automatic enrolment is likely to drive significant growth in pension assets under management in the medium to long term, which will be available to invest in the UK economy. The success of automatic enrolment depends on consumers being confident in saving for their pension which, in turn, depends on the ongoing value for money delivered by the pension scheme into which they invest.

The general principle that consumers should take responsibility for their decisions

14. While we believe that consumers should take responsibility for their decisions, in this instance consumers may be automatically enrolled into the default fund of their employer's scheme without making any decision. In addition, information asymmetries and the complexity of assessing value for money may deter consumers from making choices about how their pension assets are invested.

15. Many scheme members are unlikely to be willing or able to take decisions about how their pension assets are managed and invested. Our proposals enable the independent bodies which monitor value for money on their behalf to have the information they need to do this.

The responsibilities of senior management

16. Our proposals place obligations on the senior management and governing bodies of firms to ensure that information about transaction costs is passed to those who need it. We consider

these obligations necessary to ensure that the interests of policyholders are properly represented within such firms.

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation

17. We recognise that different firms may manage money for workplace pension schemes in different ways. We have therefore sought to set out a regime that does not impose a significant burden on different types of firms, but sets out a straightforward standard approach to calculating transaction costs.

The desirability of publishing information relating to persons subject to requirements imposed under FSMA, or requiring them to publish information

18. We believe that our proposals do not undermine this principle. Our proposed rules would promote greater transparency of information about transaction costs. Our proposals do not require asset managers or governance bodies to publish, or make publicly available, confidential or commercially sensitive information.

The principle that we should exercise our functions as transparently as possible

19. Transaction cost disclosure has been widely discussed. Jointly with the DWP, we published a Call for Evidence in March 2015. During the course of developing our proposed rules, we have met with firms and experts in transaction cost analysis. We have also met with consumer groups and other interested stakeholders. We have taken into account input from stakeholders in advance of our formal consultation on our proposed rules.

20. In formulating these proposals, the FCA has had regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime (as required by s. 1B(5)(b) FSMA). The intention of disclosing transaction costs is not to address the risk of financial crime, but we do not consider that it creates any greater risk of financial crime.

Expected effect on mutual societies

21. Section 138K of the FSMA requires us to state whether, in our opinion, our proposed rules have a significantly different impact on authorised persons who are mutual societies, in comparison with other authorised persons.

22. We see no reason why our proposed rules would impact a firm differently based on the structure of the provider.

Compatibility with the duty to promote effective competition in the interests of consumers

23. In preparing the proposals as set out in this consultation, we have had regard to our duty to promote effective competition in the interests of consumers under section 1B(4) of the FSMA. This duty applies in so far as promoting competition is compatible with advancing our consumer protection and/or integrity objectives.

24. The OFT market study concluded that the buyer side of the workplace pensions market was one of the weakest that they have encountered in recent years. Further, automatic enrolment will bring disengaged and potentially vulnerable consumers into pension saving for the first time. Many of these consumers will not express any choice in how their pension savings are managed and invested.

25. Our proposals for transaction cost disclosure are designed to ensure that the interests of relevant consumers are protected. In addition, our proposals will increase the amount of information available to governance bodies and their advisers. We believe that, over time, this will result in more engaged and informed customers, promoting more effective competition between firms in the interests of consumers.

Equality and diversity

26. We are required under the Equality Act 2010 to 'have due regard' to the need to eliminate discrimination and to promote equality of opportunity in carrying out our policies, services and functions. As part of this, we conduct an equality impact assessment to ensure that the equality and diversity implications of any new policy proposals are considered.

27. The outcome of the assessment in this case is stated in paragraph 1.19 of the Consultation Paper.

Legislative and Regulatory Reform Act 2006 (LRRA)

28. We have had regard to the principles in the LRRA for the parts of the proposals that consist of general policies, principles or guidance and consider that the proposals reflect these. We set out in paragraphs 11ff of this annex how we consider these proposals to be transparent, accountable and proportionate. The proposals address the disclosure of transaction costs, consistent with the obligations placed on IGCs and trustees of certain pension schemes by the new governance obligations set out in COBS 19.5 and SI 2015/879. They are targeted at an area highlighted by the OFT review of the DC pension market.

29. We have had regard to the Regulators' Code for the parts of the proposals that consist of general policies, principles or guidance. We consider that these proposals provide greater clarity for relevant market participants as to how to comply with existing obligations to disclose information about transaction costs. We consider that they set out a regime that is relatively straightforward and not overly prescriptive. They address an area that, as explained in Chapter 1, has been highlighted by the OFT as being a risk. The guidance we set out clarifies the expectations of firms in complying with the rules proposed here.

Appendix 1
Draft Handbook text

PENSION SCHEMES (DISCLOSURE OF TRANSACTION COSTS AND ADMINISTRATION CHARGES) INSTRUMENT 2017

Powers exercised

A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137A (The FCA's general rules);
(2) section 137T (General supplementary powers); and
(3) section 139A (Power of the FCA to give guidance).

B. The rule-making provisions listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Amendments to the Handbook

D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

E. The Conduct of Business sourcebook (COBS) is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Pension Schemes (Disclosure of Transaction Costs and Administration Charges) Instrument 2017.

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

Amend the following definitions as shown.

IGC	(in *COBS* 19.5 and *COBS* 19.8) an independent governance committee established by a *firm* with terms of reference which satisfy COBS 19.5.5R with the purpose, in summary, to represent the interests of *relevant policyholders* in the *firm's relevant schemes*.	
occupational pension scheme	(a)	(in *COBS* 19.8) a "relevant scheme" for the purposes of regulation 25 of the Occupational Pension Schemes (Scheme Administration) Regulations (SI 1996/1715) as defined in paragraph 1 of those Regulations which is, in summary, an occupational pension scheme (as defined in section 1(1) of the Pension Schemes Act 1993) which provides money purchase benefits (as defined in section 181(1) of that Act) with certain exceptions.
	(~~a~~b)	(otherwise) (a scheme specified in article 3(1) of the *Regulated Activities Order* (Interpretation)) which is, in summary, a pension scheme established for the purpose of providing benefits to people with service in employments of a prescribed description.
relevant scheme	(1)	(except in *FEES* 6, *COBS* 19.5 and *COBS* 19.8) a *collective investment scheme* managed by an *EEA UCITS management company*.
	(2)	(in *FEES* 6) a scheme or arrangement (other than the *compensation scheme*) for the payment of compensation (in certain cases) to customers (including customers outside the *United Kingdom*) of *persons* (including *persons* outside the *United Kingdom*) who provide financial services (including financial services provided outside the *United Kingdom*) or carry on a business connected with the provision of such services.
	(3)	(in *COBS* 19.5 and *COBS* 19.8) a *personal pension scheme* or *stakeholder pension scheme* for which direct payment arrangements are, or have been, in place, and under which contributions have been paid for two or more *employees* of the same employer. 'Direct payment arrangements' has the same meaning as in section 111A of the Pension Schemes Act 1993, that is, arrangements under which contributions fall to be paid by or on behalf of the employer towards the scheme (a) on the employer's own account (but in respect of the employee); or (b) on behalf of the employee out of deductions from the employee's earnings.

Annex B

Amendments to the Conduct of Business sourcebook (COBS)

After COBS 19.7 (Retirement risk warnings) insert the following new section. The text is new and is not underlined.

19.8 Disclosure of transaction costs and administration charges information in connection with pension schemes

Interpretation

19.8.1 R In this section:

(1) "administration charges", in relation to a member of a pension scheme, means any of the following to the extent that they may be used to meet the administrative expenses of the scheme, to pay commission or in any other way that does not result in the provision of pension benefits for or in respect of members:

(a) any payments made to the scheme by, or on behalf or in respect of, the member; or

(b) any income or capital gain arising from the investment of such payments; or

(c) the value of the member's rights under the scheme;

but an administration charge does not include any charge made for costs:

(d) incurred directly as a result of buying, selling, lending or borrowing *investments*; or

(e) incurred solely in providing benefits in respect of the death of such a member; or

(f) in complying with a court order, where that order has provided that the *operator*, trustee or manager of the scheme may recover those costs; or

(g) arising from earmarking orders or pension sharing arrangements pursuant to regulations made under section 24 or 41 of the Welfare Reform and Pensions Act 1999.

(2) "anti-dilution mechanism" is any method used to the benefit of an investment vehicle to offset the impact of inflows or outflows from that investment vehicle, whether by way of:

(a) a levy; or

(b) any adjustment enabling further investment into, or redemption of investments from, the investment vehicle.

(3) "arrangement", in connection with a *relevant scheme* or *occupational pension scheme*, is any investment vehicle available to scheme members for the investment of their pension contributions.

(4) "linear", in relation to a *derivative*, means that the price of the *derivative* varies in line with the price of the asset(s) underlying the *derivative*.

(5) "non-linear", in relation to a *derivative*, means that the price of the *derivative* does not vary in line with the price of the asset(s) underlying it, for example an *option*.

(6) "transaction costs" are costs incurred as a result of the buying, selling, lending or borrowing of *investments*.

Application

19.8.2 R This section applies to:

(1) an *operator* of a *relevant scheme*; and

(2) a *firm* which holds information needed for the calculation of transaction costs or administration charges in the course of providing services in connection with:

(a) a *relevant scheme*;

(b) an *occupational pension scheme*;

(c) an arrangement; and/or

(d) an investment vehicle in which an arrangement is directly or indirectly invested.

Purpose

19.8.3 G (1) The purpose of the *rules* in this section is to enable governance bodies of workplace pension schemes to meet their obligations as set out in (2) and (3) by obliging *firms* which hold the relevant information to calculate transaction costs to a common standard and provide that information and information on administration charges to governance bodies.

(2) An *operator* of a *relevant scheme* is obliged under *COBS* 19.5.7R(2) to take reasonable steps to provide its *IGC* (or *governance advisory arrangement*) with all information reasonably requested by it for the purpose of carrying out its role. The role of an *IGC*, under *COBS* 19.5.5R(2), must include the assessment of value for money

delivered by *relevant schemes* through the assessment (among other things) of transaction costs.

(3) The trustees or managers of an *occupational pension scheme* are obliged to calculate, insofar as they are able to do so, the transaction costs borne by scheme members, and assess the extent to which those costs represent good value for members. (See regulation 25 of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715) as amended by the Occupational Pension Schemes (Charges and Governance) Regulations 2015 (SI 2015/879)).

Obligation to disclose transaction costs and administration charges

19.8.4 R A *firm* must respond in a reasonable time and in a reasonably acceptable format to a request for information relating to transaction costs and administration charges relating to a particular arrangement (or any investment vehicle in which the arrangement is directly or indirectly invested) over a period of time from:

(1) an *operator* of a *relevant scheme*; or

(2) the trustees or managers of an *occupational pension scheme*; or

(3) another *firm* seeking to comply with its obligations under this section.

19.8.5 R In responding to the request referred to in *COBS* 19.8.4R, the *firm* must:

(1) calculate the transaction costs incurred in the arrangement or investment vehicle to which the request relates (including transaction costs incurred in any investment vehicle in which the arrangement or investment vehicle is directly or indirectly invested) for that period in accordance with this section;

(2) disclose the results of the aggregation of those transaction costs to the requesting *person*, along with a breakdown of the identifiable elements of those costs;

(3) disclose the administration charges incurred in that arrangement or any investment vehicle to which the request relates (including administration charges incurred in any investment vehicle in which the arrangement or investment vehicle is directly or indirectly invested) for that period; and

(4) provide other relevant information which would or may assist in making comparisons between the costs or charges in (1) to (3) and those costs or charges of other pension schemes where available.

19.8.6 G (1) The breakdown of identifiable costs should at least include taxes, explicit fees and charges, and costs in connection with securities lending and borrowing**.**

(2) Other relevant information regarding transaction costs or administration charges might include, in relation to each arrangement (or investment vehicle in which the arrangement is directly or indirectly invested): the investment return, measures of risk, portfolio turnover rate, proportion of securities loaned or borrowed, costs other than transaction costs, and typical and maximum levels of entry, exit and switching costs. This is not an exhaustive list, and *firms* should use discretion based on the composition of each particular arrangement (or investment vehicle in which the arrangement is directly or indirectly invested).

(3) Where it is not possible to calculate the amount of transaction costs or administration charges attributable to an arrangement (or investment vehicle in which the arrangement is directly or indirectly invested), a pro rata approach may be used, which assumes that transaction costs and administration charges are incurred evenly over time. A pro rata approach may also be used where information is not available for a full period or in other situations where the provision of information would otherwise be subject to unreasonable delay.

(4) When calculating administration charges for a default arrangement, *firms* should have regard to *COBS* 19.6 (Restriction on charges in qualifying schemes) and the Occupational Pension Schemes (Charges and Governance) Regulations 2015 (SI 2015/879).

Taking reasonable steps to obtain necessary information

19.8.7 R If a *firm* does not have the information necessary to comply with *COBS* 19.8.4R and *COBS* 19.8.5R, then it must:

(1) take reasonable steps to obtain that information; or

(2) where, having taken such reasonable steps, the *firm* remains unable to comply with *COBS* 19.8.4R and *COBS* 19.8.5R, provide a written explanation to the requesting party explaining why, including the percentage of *investments* in the arrangement (or investment vehicle in which the arrangement is directly or indirectly invested) for which information cannot be obtained, and indicating the categories of *investments* involved.

19.8.8 G (1) In taking reasonable steps to obtain information about transaction costs or administration charges, a *firm* should request the information from other *firms* involved in providing services in connection with the *relevant scheme*, *occupational pension scheme*, arrangement, or investment vehicle in which the arrangement is directly or indirectly invested.

(2) A *firm*, when seeking information about transaction costs or administration charges, should consider the materiality of that information to the calculation of costs and charges overall for each arrangement, in particular the degree to which it is necessary to look

through to transactions in underlying investment vehicles in order to arrive at a fair assessment of the costs or charges of each arrangement.

Calculation of transaction costs for buying and selling transactions

19.8.9 R A *firm* must calculate the transaction cost of buying or selling an *investment* as the difference between arrival price (AP) and execution price (EP) of that *investment*, multiplied by the number of units of, or in, the *investment* transacted, as follows:

(1) AP and EP are determined in accordance with this section;

(2) where an *investmen*t is purchased:

transaction cost = (EP-AP) x (units); and

(3) where an *investment* is sold:

transaction cost = (AP-EP) x (units).

Arrival Price (AP)

19.8.10 R A *firm* must determine the arrival price (AP) as follows:

(1) for a *transferable security*, or other *investment* for which there are frequent opportunities to dispose of, redeem, or otherwise realise at a price publicly available to market participants and that is either a market price or a price made available or validated by valuation systems independent of the *issuer*:

(a) the market mid-price at the time the order was transmitted to another *person* for execution or was executed, whichever is earlier; or

(b) if no such price is available, then the last available mid-price on the day the order was *executed*, or if this is not available, the closing mid-price on the day before; or

(c) if the order to transact was executed on a day other than the day it was transmitted to another *person* for execution, the market opening mid-price on the day of execution, or if this is not available, the closing mid-price the day before; or

(d) if the order was *executed* during an auction, the most recently available mid-price of the asset prior to the auction should be used; or

(e) if an order is transmitted to another *person* for execution outside trading hours, the subsequent market opening mid-price.

(2) for an investment fund or other vehicle priced on a periodic basis:

(a) for a dual-priced vehicle, the fair-value mid-price of the vehicle at the pricing point when the transaction took place; or

(b) for a single-priced vehicle, the fair-value price, prior to any dilution adjustment, of the vehicle at the pricing point when the transaction took place.

(3) for any other *investment* which does not fall into (1) or (2):

(a) the most recent independent valuation prior to the order to transact being executed, or, if earlier, transmitted to another *person* for execution, adjusted appropriately for market movements using an appropriate benchmark index; or

(b) if no such valuation is available, then an estimate based on a reasonable appraisal of the fair value of the asset prior to the order to transact being executed.

Arrival Price (AP): supplemental provisions for derivatives

19.8.11 R When determining the arrival price (AP) for a *derivative* where there is no publicly available price, a firm must determine the fair value price of the *derivative*.

19.8.12 G (1) When considering the basis for determining transaction costs relating to *derivatives*, a *firm* should take into account:

(a) the existence of any multiplier or scalar in arriving at the correct number of units;

(b) the nature of the *derivative*, in particular whether it is linear or non-linear;

(c) the availability and transparency of prices of the *derivative* itself;

(d) the nature and value of the assets underlying the *derivative*, including their price transparency and relative proportions within that *derivative*; and

(e) any other costs associated with the *derivative*.

(2) For a linear *derivative*, a *firm* should use a weighted average of the values of underlying assets.

(3) For a non-linear *derivative*, a *firm* should adopt a fair value approach in line with prevailing market conventions to determine the value of the *derivative* at the time of transmission of the order to transact.

Arrival Price (AP): supplemental provisions for foreign exchange

19.8.13 R A *firm* must, in relation to a transaction involving foreign exchange, determine the arrival price using a fair reflection of the prevailing appropriate exchange rate at the appropriate time.

19.8.14 G In choosing a foreign exchange rate to apply when determining an arrival price, a *firm* should avoid using a rate available with a single counterparty, even where an agreement exists with that single counterparty to undertake all foreign exchange transactions.

Execution Price (EP)

19.8.15 R A *firm* must determine the execution price (EP) as the price at which a transaction is executed including all charges, commissions, taxes and other payments associated with the transaction, directly or indirectly, where those payments are made from the assets of the arrangement or of any investment vehicle in which the arrangement is directly or indirectly invested.

Calculation of transaction costs for lending and borrowing transactions

19.8.16 R A *firm* must calculate the transaction cost of a loan transaction as the difference between the charge paid by the ultimate borrower in relation to that loan and the amount received by the arrangement (or underlying investment vehicle).

19.8.17 G The amounts used to calculate the transaction cost of a loan transaction should include all fees, commissions, charges and other costs levied by intermediaries involved in the transaction regardless of the legal structures involved.

19.8.18 R To determine the transaction cost of a borrowing transaction, a *firm* must use the amount paid for the loan.

Aggregation

19.8.19 R The *firm* must aggregate and disclose, separately, the following transaction costs for each arrangement or investment vehicle and period to which the request relates:

(1) the sum of the transaction costs for buy and sell transactions excluding adjustments for anti-dilution mechanisms (see *COBS* 19.8.20R); and

(2) the sum of the transaction costs for lending and borrowing transactions.

Treatment of anti-dilution mechanisms

19.8.20 R A *firm* using any sort of anti-dilution mechanism in connection with an arrangement may factor this into the aggregate transaction costs calculation

as follows:

(1) where a levy is used, the monetary value of that levy may be subtracted from the aggregate transaction costs; and

(2) where an adjustment is made by enabling further investment into or redemption from an investment vehicle, the value of the benefit accruing to the investment vehicle may be subtracted from the aggregate transaction costs.

Financial Conduct Authority

PUB REF: 005179

© Financial Conduct Authority 2016
25 The North Colonnade Canary Wharf
London E14 5HS
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk
All rights reserved