

## **Regulator Assessment: Qualifying Regulatory Provisions**

**Title of proposal:** Extending selected MiFID II provisions to Occupational Pension Scheme (OPS) firms

**Lead regulator:** FCA

**Date of assessment:** 1 March 2018

**Commencement date:** 2 April 2018

**Origin:** Domestic extension of EU legislation

**Does this include implementation of a Cutting Red Tape review?** No

**Which areas of the UK will be affected?** Whole of the UK

### **Brief outline of proposed new or amended regulatory activity**

Based on forthcoming reforms under the second Markets in Financial Instruments Directive (MiFID II), the FCA has decided to extend the new standards in three areas (research & inducements, best execution and taping) to Occupational Pension Scheme (OPS) firms. OPS firms are FCA-authorized entities established by pension scheme trustees to manage the assets of a specific pension scheme or welfare trust.

The MiFID II research and inducements changes require firms to be more accountable when they procure external third party research in relation to portfolio management or investment advice services and pass these costs onto clients. They seek to ensure portfolio managers or advisers avoid the potential conflict of interest and lack of transparency created where such benefits are provided to them by firms such as brokers in return for paying higher trading fees or directing order flow to them, at a cost to the underlying investor.

MiFID II's best execution reforms seek to ensure more transparency over how firms place, transmit or execute orders on behalf of clients, for example, how a portfolio manager selects the brokers or venues they use to buy and sell securities on behalf of their clients. Achieving better execution quality, such as better prices and lower transactions costs, can lead to significant incremental benefits for investors due to the frequency of transactions and the compounding nature of cost savings over time e.g. in a portfolio management context.

Finally, taping places requirements on firms to record telephone conversations or other electronic communications that relate to transactions in financial instruments. It helps the FCA to detect and investigate instances of market abuse by firms or their employees, and / or potential non-compliance with other conduct of business requirements. However, taping also assists firms when seeking to monitor their own employees for potential abusive or inappropriate conduct (e.g. personal account dealing based on inside information), or to resolve commercial disputes, for example where a trading error occurs and there is a dispute

between two firms as to the terms originally agreed. MiFID II formalises a requirement on firms to keep such records.

OPS firms are outside the scope of MiFID II; however they undertake similar investment management activity to MiFID portfolio managers. We have decided to apply selected MiFID II standards to OPS firms on a discretionary basis to ensure they deliver good outcomes when managing scheme assets on behalf of trustees and scheme beneficiaries.

Aside from these changes, we are also explicitly dis-applying, with a few exceptions, most other areas of our existing conduct of business (COBS) rules, since they are not relevant to OPS firm activities. This aims to make it easier for OPS firms to understand which COBS provision are relevant to them, and which are not, rather than our previous approach indicating that COBS generally applied to OPS firms thus leaving it to the firm to assess which were relevant.

### **Which type of business will be affected? How many are estimated to be affected?**

The businesses affected will be Occupational Pension Schemes (OPS) firms. There are 16 of these firms in the UK, managing around £250bn of assets that are MiFID financial instruments.<sup>1</sup>

Based on our proposals, there will also be consequential changes to firms that provide both execution and research services to OPS firms (e.g. brokers) in that they will be required to extend separate pricing of services to these firms. However, since we already propose to require these firms to undertake this when supplying services to MiFID investment firms and firms carrying out non-MiFID collective portfolio management activities, we anticipate no direct additional cost or impact from this incremental extension.

<b>Price base year</b>	<b>Implementation date</b>	<b>Duration of policy (years)</b>	<b>Business Net Present Value</b>	<b>Net cost to business (EANDCB)</b>	<b>BIT score</b>
2016	2 April 2018	10	-4.0	0.5	2.3

### **Please set out the impact to business clearly with a breakdown of costs and benefits**

We sent out a questionnaire to all OPS firms in December 2016, asking for data to support its proposals for consultation in respect of the MiFID II changes which were to be applied to them. We received 10 responses to this survey. The proposals were then consulted on in March 2017 where we sought feedback on the proposals and the accompanying cost benefit analysis (CBA).

In the following section we set out our estimates for one-off and ongoing costs for the extension of MiFID standards on inducements (research), best execution and taping to OPS firms. The details presented below are drawn from underlying analysis conducted for the CBA in CP17/08 and additional calculations undertaken for this impact assessment in relation to the familiarisation & GAP analysis costs for the disapplication of most other conduct rules.<sup>2</sup>

#### Extension of the MiFID II research and inducements standard to OPS firms

<sup>1</sup> In the original CBA conducted for CP17/08 we estimated that there were 17 OPS firms according to FCA permissions data. In preparing this impact assessment we have re-estimated this number at 16 firms.

<sup>2</sup> Where relevant, the costs in the following section have been adjusted relative to those in the original CBA to account for the change in the number of OPS firms from 17 to 16. Where this is the case, these figures are otherwise estimated utilising the same underlying methodology as used in the CBA.

Costs from extending the MiFID II inducements and research requirements will only arise for OPS firms where they manage assets directly. Where they outsource all of their investment management activity, we believe the OPS firm itself will not incur any direct costs. Of the 10 responses to our survey, three respondents indicated that they outsourced all of their portfolio management<sup>3</sup>.

For those OPS firms that do not outsource the portfolio management of all of the pension scheme or welfare trust assets, we have calculated potential one-off and ongoing costs based on the survey returns. For firms which did not fully outsource and indicated that they would experience costs, we have assumed that they will seek to implement a 'research payment account' (RPA) model with consequently higher compliance expense due to the enhanced accountability and governance this requires.

#### *One-off costs<sup>4</sup>*

Of the seven OPS firms who reported that they do not fully delegate portfolio management to third parties, five reported that they were likely to incur one-off costs to comply with our proposal, while two noted zero costs.<sup>5</sup>

OPS firms indicating one-off costs stated that they expect these to include the renegotiation of current commission sharing agreements (CSAs) to move to RPAs, legal fees and changes in systems, training and governance to implement the new approach. Based on survey responses, we have estimated an average one off cost per firm of £35,000.

To calculate the likely one-off costs across the full population of sixteen OPS firms, we calculated a range with a lower and upper bound. The lower bound takes the proportion of firms who do not outsource all of their portfolio management and who provided specific estimates of one-off costs (40%) and applies the average cost per firm to 40% of the 16 firms in the population. This provides a lower bound one-off cost estimate of £224,000. For the upper bound, we assume costs are incurred by all firms that don't outsource (70% based on our survey), and therefore apply the average cost across 70% all the OPS firms. This gives an upper bound one-off cost figure of £392,000.

#### *Ongoing costs*

By contrast to one-off costs, only two OPS firms who do not fully outsource their portfolio management provided specific estimates of ongoing costs from the proposals. These costs could relate to the need to regularly review budgets and the cost of the RPA infrastructure, especially if it is outsourced to a third party provider. Two other firms stated that they expected some costs but did not provide any estimates, while another three stated they anticipated no additional ongoing costs from meeting enhanced MiFID II standards.<sup>6</sup>

We assume the lower provision of cost figures for ongoing expenses may be because some OPS firms take the view that once an RPA and revised governance arrangements are initially put in place, ongoing costs to monitor and oversee spending on research may not materially differ from those currently incurred when overseeing existing dealing commission arrangements. Based on survey responses that gave some indication of likely costs and figures provided, the average ongoing cost per firm is estimated to be £20,833.

We estimate a range for ongoing costs using the same methodology as described above based on the survey where our lower range assumes 20% of firms incur costs whilst our upper range

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<sup>3</sup> Firms to which an OPS firm would outsource will be conducting MiFID portfolio management activity, and so these firms are already required to meet MiFID II standards as a matter of EU law and will have already incurred such costs accordingly. Therefore outsourcing by OPS firms does not pass-through additional costs for the firm to which they delegate.

<sup>4</sup> For the purposes of assessing costs for OPS firms, we exclude from our analysis any transfer in existing research costs between the firm and the client. We also do not consider as costs any potential changes in tax treatment as a result of the reforms, such as the application of VAT to research services, which is a matter for HMRC.

<sup>5</sup> These firms justified their response by outlining that they have already adopted a model of paying for research separately as a direct cost to the OPS firm, rather than funding it through execution services – hence they consider they are already compliant with our rules.

<sup>6</sup> Two of these respondents were the same firms who believed that they would incur no one off costs as they were already compliant with the rules by directly paying for research.

assumes 70% of firms incur costs. This provides a lower bound ongoing cost estimate of £66,667 and an upper bound ongoing cost figure of £233,333.

#### Extension of the MiFID II best-Execution standards to OPS firms

In line with the approach adopted when implementing MiFID, the FCA has opted for a general application of the MiFID II provisions to OPS firms, on a discretionary basis, where their business involves the execution of orders, placing orders for execution as part of portfolio management services, or the reception and transmission of orders to other entities for execution.

##### *One-off costs*

While the MiFID II best execution obligations are broadly comparable to the requirements of the current FCA rules, firms will need to familiarise themselves with the new requirements and make the necessary adjustments to their current arrangements. Since OPS firms have told us that they are expected already to have the necessary arrangements in place (in line with their current obligations), they are likely to face costs of minimal significance associated with the new requirements in relation to upgrading their execution arrangements and policies to reflect the enhanced MiFID II standards.

The main one-off costs firms will face are in relation to the publication of an annual report (MiFID II RTS 28<sup>7</sup>) setting out the top five venues or brokers to which client orders were sent in the preceding year as well as a summary of execution quality achieved over that period. This will primarily involve the initial implementation of IT software or systems to enable OPS firms to aggregate and format existing data on where they have placed or executed orders in a 12-month period across different asset classes to enable them to produce the annual reports on the top five venues or brokers they have used, alongside a qualitative summary of the execution quality they obtained. There will be subsequent, but lower, ongoing costs of producing the report each year, which are discussed below.

Based on survey responses from OPS firms that do not outsource all of their portfolio management activity, four firms provided estimates of specific one-off costs they would incur, while three did not. The average cost per firm based on survey responses and the figures provided is estimated to be £49,730.

We calculate a lower bound of one-off costs across the sector by taking the proportion of firms who do not outsource all of their portfolio management and who provided specific estimates of one-off costs in our survey (40%) and applying the average cost per firm to 40% of the full 16 firms in the population. This provides a lower bound one-off cost estimate of £318,272. For the upper bound, we assume average one-off costs are incurred by all OPS firms that do not outsource all of their portfolio management (assumed at 70% based on survey responses), to give an upper bound total one-off cost figure of £556,976

##### *Ongoing costs*

We expect ongoing costs to be lower than one-off costs, as once new systems are in place based on the new best execution standards, the monitoring and review processes will not be materially different from what firms are already expected to do under the existing rules. Additional ongoing costs will mainly be related to the OPS firms' annual production of RTS 28. Based on survey responses and figures provided, we estimate an ongoing cost per firm of £21,880.

We estimate a range for ongoing costs using the same methodology as described above based on the survey where our lower range assumes 30% of firms incur costs whilst our upper range assumes 70% of firms incur costs. This provides a lower bound ongoing cost estimate of £105,024. For the upper bound, we assume average ongoing costs are incurred by all OPS firms that do not outsource all of their portfolio management (assumed at 70% based on survey responses), to give an upper bound total one-off cost figure of £245,056.

#### Extension of the MiFID II Taping requirements to OPS firms

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<sup>7</sup> MiFID II Regulatory Technical Standard (RTS) 28  
<https://www.handbook.fca.org.uk/handbook/COBS/11/Annex1EU.htm>

MiFID II introduces a requirement for firms to record telephone conversations and electronic communications when undertaking specific client order services and dealing on their own account. We have a domestic taping policy in place already, which for the most part aligns with MiFID II. The FCA has made rules to extend to OPS firms the new taping requirements under MiFID II in relation to their dealing activities on behalf of the schemes they manage, and remove the existing qualified exemption available to them under our COBS rules.

Seven OPS respondents stated that they already tape conversations. For these firms, we believe the additional costs of meeting the MiFID II requirements would be relatively low. For the remaining three respondents we would expect that they would incur additional costs as a result of our discretionary proposal to tape.

#### *One-off costs*

For those firms that already have a taping solution in place, the additional costs of meeting the MiFID II requirements would be relatively low. These would include one-off costs of compliance (including general familiarisation), policy development and staff training. For OPS firms who do not currently tape, they will have the larger cost of installing new taping infrastructure, in addition to the above. Our cost estimates include mobile recording as well as fixed recording, using a ratio of fixed users to mobile of 1:0.44. Based on the assumption that 30% of the OPS population do not currently tape, we estimate that the one off costs of applying the taping requirements to OPS firms will range between £56,695 and £63,945.<sup>8</sup>

#### *Ongoing costs*

The main ongoing costs for all firms will result from additional monitoring and putting in place storage arrangements. In the case of those firms that already tape; they will have to extend existing storage capacity to retain records for up to 5 years on a rolling basis. We assume this would be done via a third party cloud. We estimate total ongoing costs for the OPS firm population will range from £53,795 to £61,045.<sup>9</sup>

#### *Disapplication of most other conduct rules*

We expect the impacted firms to read and digest the relevant changes and subsequently perform a gap analysis where they will familiarise themselves with the detailed requirements of new the new rules and guidance, and check their current practices against these expectations.

Based on assumptions on the time required to undertake this analysis and the cost of this time to firms, we estimate that firms will incur an average cost of £688 to undertake this work. In aggregate this indicates an overall cost of less than £100,000.<sup>10</sup>

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<sup>8</sup> As illustration of how these costs arise we can consider an example of a firm needing to record the communication of one of its staff. Initial hardware, installation and first year storage capacity would cost, between £391 and £441 per individual (£335 for telephone lines and installation and £6 for the first year's storage capacity. If the lines are used on average 70% of an 8 hour working day and speech is recorded at between 13 and 16 kbits per second in WAV format. On that basis each line will generate about 40 mb of data. Across a 260-day working year the total data per user is 10.4 GB. Assuming that a backup copy is kept and this information is stored in a third party cloud, we estimate cost storage per user at £6 per year. We have also included between £50-100 per user per year for maintenance and other associated miscellaneous expenses including staff costs. Based on figures from previous analysis we estimate that for every landline recorded, there will be 0.44 mobile phones recorded. We estimate costs for the second and subsequent years will reduce to between £371 and £421 per user. However, we estimate that for firms that already record conversations and communications the largest expense will arise with retaining records from at least 6 months to a minimum of 5 years. We do not expect these storage costs to be material.

<sup>9</sup> See previous footnote

<sup>10</sup> The assumptions used to estimate these costs have been derived from a research project on compliance costs that involved consultation with firms and trade bodies, discussions with vendors, a review of previous CBAs, internal FCA consultation, and desk-based research. To put a cost on time, we have sourced salary information for a range of occupations in financial services. Figures for large and medium firms are based on the 2016 Willis Towers Watson UK Financial Services Report. Small firm salaries were sourced from a systematic review of adverts on the website of Reed, cross-referenced with other publicly available sources. We add an allowance for overheads of 30% to all time costs to account for non-wage labour costs, as advocated by the HM Treasury Green Book.

We do not expect any direct costs or savings to arise from the actual retention or disapplication of certain existing COBS provisions for OPS firms. For those provisions that are retained, OPS firms already have to apply these rules and will not need to make any changes. Where we have switched off provisions, we have done so on the basis they will not be applicable to OPS firm activity in practice. On that basis, we assume there will be neither costs nor savings to OPS firms from these changes.

The changes proposed to extending selected MiFID II provisions to OPS firms are expected to benefit consumers and society. For example, society will benefit from greater transparency from OPS firms on how much was spent on research, which in turn should help trustees get value for money for their consumers. The benefits to consumers and society are likely to exceed costs to firms. However, under the Act, benefits to consumers and society are out of scope for impact assessments. These benefits are considered in our cost benefit analysis (CBA) prior to rule changes.

**Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.**

The relevant FCA consultation for these provisions is: FCA, March 2017, CP17/8: Markets in Financial Instruments Directive II Implementation – Consultation Paper V (including changes to conduct rules for Occupational Pension Scheme firms)  
<https://www.fca.org.uk/publication/consultation/cp17-08.pdf>

The relevant FCA handbook notice for these provisions is: FCA, October 2017, Handbook Notice No.48, <https://www.fca.org.uk/publication/handbook/handbook-notice-48.pdf>