COSTS & CHARGES INDEPENDENT ADVISORY BOARD

12:30 10 OCTOBER 2016

CAMOMILE COURT, 23 CAMOMILE STREET, LONDON, EC3A 7LL

BOARD ATTENDEES

Graham Vidler	PLSA (Chair for the meeting)
Yvonne Braun	ABI
Teresa Fritz	FSCP
Jeff Houston	Local Government Association
Thomas Mercier	PLSA DB Council
Chris Hitchen	RPMI
David Will	The Society of Pension Professionals
Andy Agathangelou	Transparency Task Force

INVESTMENT ASSOCIATION ATTENDEES

Jonathan Lipkin
Imran Razvi
Mark Sherwin

APOLOGIES

Mark Fawcett	NEST
Alex Pocock	The Society of Pension Professionals
David Hare	Phoenix Life IGC
Richard Butcher	PTL

PROCEEDINGS

1. Independent Advisory Board closed session

The Board held a closed session without IA attendance prior to the main meeting.

2. IA feedback and discussion on Board comments received to date

Following the publication by the FCA the previous week of its consultation paper on transaction cost disclosure in workplace pensions, the IA provided the Board with an update of the implications of the FCA's paper for the IA's code and the fit between the FCA's draft rules and the data points in the IA code.

The key message emphasised by the IA was that the paper and its contents had been anticipated and were in line with what the IA had been expecting – notably the application of the PRIIPs methodology for the calculation of transaction costs. The IA code already incorporated this methodology and a significant number of the data points highlighted by the FCA in its draft rules and guidance. The FCA work was limited in scope to the workplace DC pensions market while the IA code was seeking to bring about consistent disclosure across the full range of products and services offered by the asset management industry.

Thus, the IA saw consistency between its own work and the direction of travel articulated by the FCA- and that the IA code could give form to the disclosures required by the regulator, which, it was noted, had not mandated the form of disclosure. It was further explained that the IA hoped that the FCA would incorporate the code into its COBS rules.

Discussion then turned to the document circulated prior to the meeting which recorded initial IA responses to the comments on the code that had been made by the Board to date. The IA noted that some issues raised needed further work on its part before being answered; and when ready the IA would return to the Board with answers or proposals.

In regard to the IA responses on Board comments to date, the following issues were raised at the meeting:

- It was suggested that inclusion of an appropriate performance benchmark in the template should be considered as it would provide an extra piece of information to contextualise realised performance. This is standard information that managers would in any case be providing to clients. An additional comment was made that any such benchmarks needed to be independently produced. The IA agreed that performance benchmarks were important pieces of information for clients. However, this raised broader questions of disclosure and the issue here was whether or not they should be included in standardised cost disclosures or separately in a performance report. It was agreed that this was a question that could be asked as part of the public consultation. The calculation of benchmarks was a further important, but entirely separate, issue that was not in scope of a project on cost disclosures.

- On cost benchmarking one Board member noted that following discussions he had held with the DWP, their focus on cost benchmarks seemed to be more in relation to disclosure to scheme members rather than from asset managers to IGCs and trustees. Full cost disclosures to members would therefore need to include a wider set of costs than just asset management costs- the full costs of providing a pension product or scheme would be needed for that purpose.

- One Board member asked why derivatives had been excluded from the reporting of investment activity? Where they were used, the purpose was to add value to an investment strategy. Given that the code accounted for their costs would it not be helpful to show them within investment activity as well? This would allow the use of derivatives to be judged in the context both of the benefit they deliver to an investment portfolio as well as their costs. The IA noted that the most important point in a cost disclosure framework was to account for the costs of derivatives and the code was comprehensive in this regard. Contextual information around the use of derivatives was not included because, unlike a security, there was usually no or only minimal consideration paid and the IA was not aware of any useful equivalent measure for derivatives to purchases and sales for securities. The Board member raising this issue agreed that presenting the value of derivative volumes may not be meaningful, but that presenting the exposure to the underlying may be helpful. The IA agreed to give this issue more thought and would return to the Board having done so.

In response to a Board question about whether the IA had considered any alternative methodologies the discussion then turned to the two areas of optionality in methodology that the IA had considered – the measurement of implicit transaction costs and portfolio turnover respectively.

Discussion on alternative methodologies for the measurement of implicit transaction costs

The IA explained to the Board the 'slippage' methodology proposed by the FCA. The IA's concern with this methodology is that as time passes from the point an order is sent to a broker for execution, that trade, the trades of other market participants and any external news/events could all cause the market to move. Under the slippage methodology all of these would be captured and reported as the costs incurred by a client. The IA had previously noted that it viewed this as a conflation of two different measures: the actual cost of trading in a given market and the quality of the trading process.

This methodology combined both spread and market impact because the 'arrival price' would be a mid-market price and the execution price would be the actual price obtained for a given trade. The IA explained that this meant it could break down the FCA approach into spread plus market impact in order to separate the cost of the spread from price movements in the market due to other factors. This was the approach followed in the IA's code.

The benefit of doing this was that it would allow a client to see the spread incurred - an actual cost - while using market impact to provide some insight on the quality of trade execution. In addition, the LGPS and FSCP had requested spreads in their templates while the Pensions Regulator's guide for DC trustees on value for money also suggested that trustees should consider separating reasonably reliable costs (eg spreads) from mere estimates (eg market impact).

There was still a choice to be made with respect to what to report for the spread – there was as yet no standardisation here. As one Board member speculated, this might have been why the FCA had gone down the route it had chosen – spreads being difficult to observe in some markets.

One Board member noted that though the IA had concerns, the arrival price methodology still sounded like it provided useful information about trading. The IA noted that the approach was routed in transaction cost analysis in equity markets but did not work so well for OTC markets. In its 2015 analysis for the FCA, Novarca had presented slippage without being detailed about the benchmark and had warned against using it for the reasons discussed earlier.

The IA again emphasised its solution to the issues posed by the FCA methodology, noting that it was going further than the regulation by breaking down slippage into spread plus market impact. This led to a discussion about the possibility of dual approaches to the calculation of implicit costs- the FCA measure plus the IA approach. Two methodologies would not be ideal for clients making comparisons. The IA explained that this is precisely why it wanted to seek the incorporation of its code into COBS rules. The issue was not one of compliance with FCA rules, which was assured. The issue was whether to go beyond the regulatory measure in the way the IA would like to.

This part of the discussion concluded with the Board noting that it might be helpful to respond in its own right to the FCA consultation.

Discussion on alternative methodologies for the calculation of Portfolio Turnover Rate (PTR)

The IA then talked the Board through its work on PTR. Three measures had been considered:

- A European measure adjusted for flows to separate out the impact of trades due to flows and trades made due to investment decisions
- A similar measure that does not adjust for flows
- A measure specified by the SEC in the US which takes the lesser of purchases or sales

All three measures provided similar trends in turnover over time, with differences in levels. The feedback from managers to the IA in this area is that clients tend to look at how turnover trends change over time rather than the levels themselves.

The IA's conclusion was that there is no right or wrong answer – for comparison of trends the precise measure used matters little – but that the SEC method is best because it is the simplest to calculate and gives the most intuitive answers. The European measure in its original form could both appear to overstate turnover levels and produce negative outcomes, and was therefore not seen as intuitive for investors. On that basis, the SEC method was the basis for the PTR measure proposed in the draft code.

A question was asked as to whether the approach would work in a Fund-of-Funds structure. The IA noted that it would be possible to report the turnover for each underlying fund but wondered what useful information this would provide at the Fund-of-Funds level. This led to another Board member asking if this meant the IA code did not capture all costs? The IA explained that it did capture all the costs of Fund-of-Funds structures.

The IA was also asked whether the SEC approach was consistent with FCA? The IA noted that the FCA had not recommended a specific measure, simply saying in guidance that firms should report PTR.

The Chair concluded the discussion by inviting Board members to send any further thoughts on this topic to the IA.

3. Next steps

The IA then outlined the next steps. The IA had discussed with the Chair that it would be happy for the Board to provide its view on the direction of travel on the code at the time of the IA's consultation, rather than issuing a full report at that stage. This would give the Board more time in its deliberations. The Board agreed that this would be a pragmatic way of proceeding.

The IA explained the need to be mindful of the timing of the FCA's consultation. The IA would aim to begin its consultation in November and conclude shortly after the FCA. The IA would then liaise with the FCA with a view to incorporating the code into COBS rules. It was agreed that the IA would keep the Board apprised of its discussions with the FCA.

The next step was for the IA to send the next iteration of the code (template plus definitions) to the Board for comment prior to the next meeting. A detailed timetable for consultation would also be provided.

4. AOB

None.

The meeting was closed promptly at 2:30.

Date of next meeting: 4 November, 10am