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Consultation Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds

Dear Sirs,

Markit is pleased to submit the following comments to IOSCO in response to its Consultation Report on *Elements of International Regulatory Standards on Fees and Expenses of Investment Funds* (the "***Consultation Report***").

Markit[1] is a leading global diversified provider of financial information services.[2] Founded in 2003, we employ over 4,000 people in 11 countries and our shares are listed on Nasdaq (ticker: MRKT). Markit has been actively and constructively engaged in the debate about regulatory reform in financial markets, including topics such as the implementation of the G20 commitments for OTC derivatives and the design of a regulatory regime for benchmarks. Over the past years, we have submitted more than 120 comment letters to regulatory authorities around the world and have participated in numerous roundtables.

Introduction

Markit's Investment Services business encompasses a range of services that enable our customers, including both buy-side and sell-side firms, to measure and report on their execution quality and to manage processes around broker evaluation and the allocation of their commission payments:

- Markit's Transaction Cost Analysis (TCA) tool[3] is an independent offering that helps financial institutions conduct analysis on their execution costs. Specifically, it provides firms with actionable insight on the quality and costs of execution in various asset classes that they will use to enhance and synchronise their execution quality management, compliance and management reporting capabilities and comply with regulatory best execution requirements.

[1] See www.markit.com for more details.
[2] We provide products and services that enhance transparency, reduce risk and improve operational efficiency of financial market activities. Our customers include banks, hedge funds, asset managers, central banks, regulators, auditors, fund administrators and insurance companies. By setting common standards and facilitating market participants' compliance with various regulatory requirements, many of Markit's services help level the playing field between small and large firms and herewith foster a competitive marketplace. For example, Markit's KYC Services provide a standardized end-to-end managed service that centralizes "Know Your Client" (KYC) data and process management.
[3] See https://www.markit.com/Product/File?CMSID=a1f8dc911f4c4663925353e9c0fb40fc for more details on Markit TCA for the buyside.

- Markit's Commission Manager[4] tool allows investment managers and sell side brokers to manage dealing commission payments by virtually aggregating commission credits, herewith supporting the efficient management of their Commission Sharing Agreements ("***CSAs***"). Markit Vote[5] helps investment managers to decide on the allocation of their research commissions based on the quality of the service they received, while also allowing them to provide feedback to their research and execution partners and, where required, transparency to regulators. Markit Calendar[6] consolidates sell-side interactions with the buy-side (events, analyst calls, etc.) and maintains a historical record of activity which further helps investment managers to allocate their commission payments appropriately in a transparent and auditable manner.

Comments

We welcome the publication of the Consultation Report by IOSCO and the opportunity to provide you with our comments. Specifically, our views can be divided into two general categories:

- First, with respect to transaction costs, we believe that: (1) CIS and their investors would benefit from being provided with a standard definition of transaction costs, such definition should include both explicit and implicit costs; (2) implicit transaction costs can be accurately measured or estimated using a variety of techniques that vary by asset class; (3) transaction costs are best analysed over a sufficiently large data set and period of time; (4) to provide meaningful analysis transaction costs are best presented in a variety of graphical ways; (5) there is limited value in providing investors only with a single fee; and (6) determining whether a CIS execution has delivered value for money depends on the context of the order and the instructions given.

- Second, with respect to hard and soft commissions on transactions, we believe that: (1) Commission Sharing Agreements (CSAs) provide an effective manner to manage commission payments and address any related conflicts of interest; and (2) the provision of a list of permitted and/or forbidden services would be helpful to create clarity, both for CIS and for research providers.

Part IV Transaction-based fees and expenses

1. Transaction costs

Question 8

- ***Should there be a standard definition of what transaction costs are? If so, which types of cost should be included in, or excluded from, such a definition and why?***
- ***What are the most effective ways of determining the value and impact of transaction costs in a CIS?***

We agree with IOSCO that a common definition of "transaction costs",[7] ideally applicable across jurisdictions, would be beneficial. This is because it would provide firms with increased clarity about how to measure their execution quality, it would also make it easier for investors to draw comparisons between different CIS and make better informed choices. We therefore support IOSCO's proposed statement of good practice that "regulators define what is meant by transaction costs" [8] and encourage the adoption of a "common definition".[9]

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[4] See https://www.markit.com/Product/Commission-Manager
[5] See https://www.markit.com/Product/Vote
[6] See https://www.markit.com/Product/Calendar
[7] See CR par. 54
[8] See CR par. 57
[9] See CR par. 54

Any definition of “transaction costs”, to be relevant and representative, should expressly contain both “explicit” and “implicit” costs:

- Explicit transaction costs

    - Explicit transaction costs are paid directly by the CIS and typically consist of items such as commissions paid, taxes, stamp duty, etc.

    - Explicit transaction costs can be measured quite easily, in particular for transactions in the equity and FX asset classes. In contrast, explicit transaction costs can be more challenging to measure for transactions in other asset classes such as fixed income. This is because commissions for these transactions are typically built into the overall execution price rather than paid separately.

- Implicit transaction costs

    - Implicit transaction costs are the actual costs of trading (excluding “explicit transaction costs”), including elements such as the so-called “slippage” of the order from its starting point, i.e., the market impact that was generated as the execution takes place.

    - Implicit transaction costs are generally more challenging to measure and various methods have been developed for this purpose. Such methods range from rather simplistic measures such Volume Weighted Average Prices (VWAP) or an Implementation Shortfall benchmark to more complex market impact and market timing based metrics. The latter, more complex methods aim to determine the extent to which trading costs incurred were caused by the market impact generated by the execution of the order or by the market momentum moving against the trade. Further, specific metrics exist to quantify certain components within TCA. For example, when examining venues, metrics such as adverse tick activity[10] or post trade reversions help identify the “toxicity” of the trading venue.[11] Importantly, any measurement of implicit transaction costs needs to consider what the CIS is trying to achieve in terms of execution as well as the difficulty of executing the order.[12]

    - In principal transactions[13] implicit transaction costs are the only costs that are evident. Given that most fixed income transactions trade in this manner it is essential for these costs to be measured and managed appropriately. While the rather opaque nature and low transaction frequency in fixed income markets makes this objective more challenging to achieve, matters will improve with the introduction of post-trade transparency regimes in major jurisdictions.[14]

In general, we believe that the most meaningful transaction cost analysis is based on a trend basis over a reasonable large data set. For example, the identification of a continuing upward trend in transaction costs for a CIS in a particular asset class, or in a subset of an asset class, would allow the user/investor to analyze in more depth as to why this is occurring.

Question 9

- Which costs, especially implicit costs, can be accurately quantified after the event?

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[10] How many times the execution takes place on an uptick if buying, and a downtick if selling.
[11] Please see http://tabbforum.com/opinions/understanding-venue-toxicity-and-detecting-predatory-counterparties for a discussion of trading venue toxicity.
[12] For example whether the instrument traded has a large spread and/or a limited turnover.
[13] For a definition of Principal Trading and Agency Trading see: http://www.investopedia.com/articles/03/012403.asp
[14] For example under MiFID in Europe from 2017.

We generally agree with IOSCO's proposed good practice that, "where the actual amount of transaction costs is known to the CIS operator after the event, that amount .. could be disclosed to the CIS and its investors."[15] Such "known" transaction costs should include both explicit and implicit costs, assuming that both can be measured with a reasonable degree of accuracy.

Our experience has shown that any benchmark calculation for transaction costs, including implicit costs, can be derived after the event and can be performed quite accurately across all asset classes as long as the overall transaction can be measured from the starting to the end point (the so-called "trading interval"). As we described in our answer to Question 8 above, some examples of implicit costs that can be accurately quantified after the event include VWAP and Implementation Shortfall. Also, as we highlighted above, it can prove challenging to gather this type of data, particularly in the fixed income asset class.

- If they cannot be accurately measured, can they be reliably estimated instead and how useful are such estimates for investors? Could such estimates be helpful to investors in considering their investment decision making process when comparing different methodologies? What methodologies could be used?

Impact models to estimate the market impact and the total costs that have been incurred for the execution of an order are widely used in equity markets today and provide, in our experience, a reliable and accurate estimate of transaction costs.[16] The use of such estimates of transaction costs is most relevant directly for firms that are executing the orders for a CIS so they can, post execution, measure their performance against the estimate. However, investors in a CIS would also obtain value from receiving estimates of transaction costs incurred as long as such numbers are appropriately presented and provided in context.

-What are the challenges of disclosing transaction costs to investors?

We agree with IOSCO that, on a standalone basis, transaction costs might not necessarily be a good indicator of "whether or not the CIS operator had entered into transactions in the interest of investors – i.e. by investing in a timely way to secure a profit or conversely by exiting a position to avoid a loss."[17] We believe that any transaction cost number must thus be seen in the broader context of the performance of the CIS and considering the reasons for any increased or decreased trading activity.

We believe that there is value in CIS providing appropriately tailored transparency to their investors around the transaction costs that they incurred and that this information can assist investors in their decision making. However, the provision of overly detailed transparency around transaction costs to CIS investors could be of limited value or might even result in creating confusion and misleading signals. This is because many CIS investors might not be experienced enough to fully understand the meaning of such numbers and the terminology used. We therefore urge IOSCO to ensure that CIS provider their investors also with adequate education and explanatory material on the relevant benchmarks and metrics used for transaction cost analysis. This will allow investors to obtain real value from the transaction cost transparency that they are provided with.

IOSCO might further want to consider whether a third-party evaluation of a CIS's TCA practices should be encouraged. The use of a third-party evaluation to measure the effectiveness of a CIS's trading practices would provide an independent, external review that would allow investors in CIS to consider a TCA score incorporating a broad set of TCA data and analytics as well as subject matter expertise. The value of such

[15] See CR par. 64

[16] IOSCO should note that the calculation of the more complex measurements of implicit transaction costs relies on the availability of accurately time-stamped trade data. While such data is typically available for equities this might not be the case today for some other asset classes.

[17] See CR par. 70

third-party service would be particularly pronounced for reviewing implicit transaction costs. We would suggest that any such reviews should be made transparent to investors.

Question 10

- To what extent can the total amount of transaction costs be predicted for future periods? Are there standards of good practice that could be applied to such disclosures?
- What are the risks of using past information in this context?

We agree with IOSCO's view that "it may be difficult to estimate a CIS's future transaction costs due to a number of practical reasons."[18] For example, each transaction is executed under different momentum, liquidity, and volatility conditions and it is very difficult, if not impossible, to forecast these and the effects they will have at some point in the future. Also, both the market environment and CISs' trading behavior will evolve over time in ways that are not predictable. It will thus be very difficult to reliably predict the total amount of transaction costs that might arise in the future.

Given the lack of alternative sources of this information, transaction costs for transactions over the most recent period could be used as indication of expected transaction costs for analysis in future periods. Analysis of historical transaction costs can be used to identify trends and to make inferences about how trading activity or conditions have evolved.

Question 11

- What experience have CIS operators and investors had of funds which apply a single fee that includes transaction costs?
- Has the level of transaction costs changed as a result of introducing this model? Are there any disadvantages to investors?

IOSCO stated that "it is sometimes suggested that the most useful form of fees and expenses disclosure for an investor would be a single figure encompassing all charges and costs, including transaction costs."[19]

In principle, it is fairly straightforward for CIS to provide their investors with a single figure for fees. However, we believe that such an aggregate number will not be the most useful approach to increasing transparency for investors around transaction costs and allowing them to make better decisions. This is because the use of a single number might often be misleading and, we believe, investors generally benefit from receiving the separate elements of the overall costs, including the various elements of transaction costs.

Question 12

- What disclosure methods are appropriate for transaction costs? If disclosure is in a numeric form, what other pieces of information will help the CIS or its investors to understand the impact of these costs on investment returns?

Displaying transaction costs in numeric form is an easy to implement approach. However, our experience with users of TCA has shown that tables of numerical data are not best suited to highlight trends or outliers. In contrast, graphical representations of transaction costs, including simplistic pie charts, line graphs and bar charts, allow display of such data in a much more user-friendly manner. Furthermore, more sophisticated graphical representations such as distribution charts, scatter plots and box and whisker plots are best suited to present trends of transaction costs over different time periods.

[18] See CR par. 66
[19] See CR par. 68

We further believe that it is important to store the relevant historic transaction cost data in a repository.[20] This is because it will allow users to query transaction costs back in time and perform quarter-to-quarter comparisons, or analyse transaction cost on the fly. Also, it allows users to drill into a particular order and determine what caused any elevated transaction costs, for example whether the order was traded too aggressively, whether too much market impact was incurred, whether the venue used was not optimal, or whether the broker or algorithm did not manage liquidity correctly.

Question 13

- What is the most appropriate comparison method to ensure the transaction produced value for money?

When trying to determine whether an order execution delivered value for money, one needs to consider what is trying to be achieved from a given order. Specifically, if the order contained specific instructions, the execution of such order produces "value for money" as long as it meets the instruction. This would be the case if, for example, the order contained particular price or volume limits and the execution was carried out within these limits or a particular benchmark was aligned to the order and this benchmark was met or exceeded.

However, where orders are given without specific instruction attached it will be more challenging to determine whether there was value for money from the transaction. We believe that a number of factors will need to be examined as part of the analysis, including whether execution was timely and the amount of slippage incurred from the trade's starting point. One could also compare the execution price to a VWAP and take into account the spreads of relevant instruments to examine whether the instrument was traded within the spread. Whilst there are many ways of analysing the relevant data to determine whether the execution delivered value for money the most appropriate approach will need to be determined by the executing party (unless otherwise directed by its client).

2. Hard and soft commissions on transactions

Question 14

- ***What are the most effective ways of mitigating conflicts of interest relating to soft commission arrangements?***

We agree with IOSCO's view that "transactions should always be executed in accordance with the principles of best execution, and the use of hard and soft commissions must not compromise this obligation."[21] We also support IOSCO's proposed standard of good practice that "CIS operators have policies and procedures in place for overseeing the use of soft commission arrangements and addressing potential conflicts of interest."[22]

Markit provides services that facilitate the operation of Commission Sharing Arrangements ("***CSAs***"). CSAs are widely established mechanisms that are used by buyside and sellside firms to manage the payments of dealing commissions to research providers. Investment managers who separate their research procurement decision from the execution decision leverage CSAs to ensure that they are receiving the best value for their clients across the research and execution services spectrum.

- ***Do lists of forbidden or permitted goods and services give enough certainty to CIS operators and investors about what can be paid for in this way?***

[20] This could be, for example, a web-based tool or a readily-accessible data archive.
[21] See CR. Par. 75
[22] See CR. Par. 89

We believe that the provision of lists of forbidden or permitted goods and services by regulators can be helpful by creating clarity for both buyside and sellside participants. We therefore support IOSCO's proposed standard of good practice that "rules, guidance or a regulatory code specify a non-exhaustive list of the types of goods and services that should not be paid for with dealing commission, or a list of types of goods and services that may legitimately be paid for with soft commission."[23]

Specifically, the U.S. Securities Exchange Commission (SEC) final interpretive release relating to the use of commissions that was published in 2006 contained very explicit guidance about which services could be considered by a fund manager in making an investment decision, beyond the "pure execution costs".[24] The publication of this release triggered a significant surge in the business as it enabled managers and independent research providers to operate confidently knowing exactly what the rules are as it relates to transaction decisions.

In contrast, we believe that the current situation in Europe ahead of the finalisation of MiFID 2 Level 2 requirements, specifically the high degree of uncertainty about regulatory expectations in relation to inducements and payments for research, is counterproductive. Our experience has shown that uncertainty about whether or not the use of CSAs will be permitted in the future[25] prevents CIS and sellside firms from transacting and stymies innovation. We urge IOSCO to ensure that firms are provided with clarity and sufficient flexibility in regards to the operational arrangements they use to manage their commission payments as long as they appropriately manage any existing conflicts of interest.

- ***What other steps might regulators and/or CIS operators take, to enable goods and services provided by the sell side to be paid for in an efficient way that does not adversely affect the interests of CIS investors?***

When discussing conflicts of interest that CIS might be exposed to in relation to commission payments, IOSCO needs to consider that every CIS is naturally motivated to deliver performance and retain its clients. We therefore do not believe that the making of payments to third parties per se is adverse to the interests of investors, but it is rather the manner in which commissions are generated, research is utilized and conflicts are addressed that need to be appropriately and transparently managed in an auditable fashion. Utilizing research effectively while focusing on best execution so the net alpha captured by the CIS can be maximized for investors is the ultimate goal that is underlying the established CSA system which should hence be supported by IOSCO and its members.

Question 15

- ***What types of disclosure concerning hard and soft commission arrangements are most useful to the board of directors of a CIS, and/or investors in a CIS?***

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[23] See CR par. 89

[24] See *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934:* SEC Release No. 34-54165 (July 24, 2006), available at https://www.sec.gov/rules/interp/2006/34-54165.pdf (providing for a safe harbour for paying a broker-dealer more than more than the lowest available commission rate for a bundle of products and services provided by the broker-dealer if the broker-dealer provides "research services" and if the fund manager has made "a good faith determination that commissions paid are reasonable in relation to the value of the products and services provided by broker-dealers in connection with the managers' responsibilities to the advisory accounts for which the managers exercise investment discretion."). https://www.sec.gov/rules/interp/2006/34-54165.pdf

[25] "While the similarity of the European Securities and Markets Authority's (ESMA) views with the FCA are publicly known, the French regulator has expressed open disagreement on dealing commission use. The Autorité des Marchés Financiers (AMF) is a strong supporter of the CSA mechanism." See: http://blog.alphametry.com/the-great-unbundling-fight-are-regulators-preparing-the-last-round/

In our experience, the distinction between “hard” and “soft” dollar arrangements has diminished over the last several years because any use of commissions to fund research is considered “soft” dollars. Our CIS customers have therefore found it to be useful and appropriate to present their investors with a break-down of all uses of commission dollars to fund various types of research. Many CIS have decided to augment such disclosures to their investors with transparency about the commission dollars that they have spent related to execution. This is based on their desire to fairly present all uses of commissions across the spectrum of research and execution.

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We hope that our above comments are helpful to IOSCO. We would be more than happy to elaborate or further discuss any of the points addressed above in more detail. In the event you may have any questions, please do not hesitate to contact us.

Yours sincerely,

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