



110 Bishopsgate
19th Floor, Suites 19-06 and 19-07
London EC2N 4AY, UK
+44 (0) 207 961 0830
www.iciglobal.org

Suite 715–717, Level 7
Two Exchange Square
8 Connaught Place
Central, Hong Kong
+852 2168 0882

1401 H Street, NW
Suite 1200
Washington, DC 20005, USA
+001 202 326 5800
www.ici.org

Mohamed Ben Salem
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

September 22, 2015

RE: Elements of International Regulatory Standards on Fees and Expenses of Investment Funds

Dear Mr. Ben Salem:

ICI Global¹ appreciates the opportunity to provide feedback on IOSCO's consultation on the elements of international regulatory standards on fees and expenses of investment funds (the "Consultation"). ICI Global's members – regulated funds² in jurisdictions worldwide – provide important advantages to investors including professional management, diversification, and reasonable cost, as well as the benefit of substantive government regulation and oversight.

We generally support the proposed statements of good practices set forth in the Consultation. Below, we respond to the following selected areas (i) transaction costs (Questions 8-13) and (ii) soft commissions – managing conflicts of interest and disclosure (Questions 14-15).

¹ The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US\$19.7 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

² For purposes of this letter, the term "regulated fund" refers to any fund that is organized or formed under the laws of a nation, is authorized for public sale in the country in which it is organized or formed, and is regulated as a public investment scheme under the laws of that country. Generally, such funds are regulated to make them eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. Such funds typically are subject to substantive regulation in areas such as disclosure, form of organization, custody, minimum capital, valuation, investment restrictions (*e.g.*, leverage, types of investments or "eligible assets," concentration limits and/or diversification standards). Examples of such funds include: US investment companies regulated under the Investment Company Act of 1940 ("Investment Company Act"); "Undertakings for Collective Investment in Transferable Securities," or UCITS, in the European Union; Canadian mutual funds; and Japanese investment trusts.

I. Transaction Costs (Questions 8-13)

We generally support the statements of good practice proposed by IOSCO relating to transaction costs in the Consultation, which build significantly upon the practice standards contained in IOSCO's 2004 Final Report on this issue. In the Consultation, IOSCO asks a number of questions that are focused on calculating the value and impact, whether actual or estimated, of transaction costs and the transparency and disclosure of transaction costs to investors. As IOSCO proceeds with this work, we caution IOSCO to be mindful that the identification, calculation, and disclosure of transaction costs is an area that has presented a longstanding regulatory challenge in many jurisdictions. Policymakers and regulators have struggled to identify both the most useful information for investors and how best to convey this information.

Improving investor understanding of mutual fund transaction costs has been an issue of focus for the U.S. Securities and Exchange Commission ("SEC") over the years, most recently in 2008/2009 and prior to that in 2003/2004. In the course of its work, the SEC has given significant consideration to improving disclosure of the costs that are borne by mutual fund investors, including being mindful of the complexities associated with identifying, measuring, and accounting for transaction costs.

The appropriate disclosure of portfolio transaction costs has likewise been considered at different times by regulators in the European Union ("EU"). As part of its consultation on the Key Investor Information document for UCITS, the Committee of European Securities Regulators ("CESR," the predecessor to the European Securities and Markets Authority), in 2007 asked for feedback on whether it should require transaction cost disclosure or inclusion in the ongoing charges figures. Upon consideration of the challenges of calculating portfolio transaction costs, CESR determined not to require such disclosure in the key investor information document at that time.³ There is, however, once again active debate in the EU regarding the disclosure and calculation of transaction costs as part of the adoption of implementing rules for the key information documents for packaged retail and insurance-based investment products ("PRIIPs") and the revised Markets in Financial Instruments Directive ("MiFID II").⁴

As national regulators continue to consider this issue and struggle with finding appropriate solutions, we emphasize that a delicate and appropriate balance must be struck between transparency and providing information that is accurate, reliable, and meaningful. It is important

³ In its response to CESR's 2007 consultation, the Investment Company Institute agreed with CESR's statements regarding the difficulties of calculating portfolio transaction costs and recommended that CESR not require the qualification of a fund's portfolio transaction costs. *See* letter from Susan M. Olson to Fabrice Demarigny, CESR Secretary General, dated February 15, 2008, available at <https://www.ici.org/pdf/22252.pdf>

⁴ As part of this debate, The Investment Association in February 2015 released a position paper on meaningful disclosure of costs and charges, available at http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0CB4QFjAAahUKFwjAn_7kPfHAhVFqx4KHdFEBWs&url=http%3A%2F%2Fwww.theinvestmentassociation.org%2Fassets%2Ffiles%2Fconsultations%2F2015%2F20150210-iacostsandchargesreport.pdf&usq=AfQjCNGZTh8JOIVivh5c0IImonucU-XeSg&sig2=sF1aa5rfnnpADBW_fIIQeg

that IOSCO's work reflects the complexity of this issue and permits jurisdictions the flexibility to weigh the costs and benefits – including unintended consequences – of providing this information.

A. Challenges with Disclosure of Transaction Costs

In the Consultation, IOSCO states 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, and asks questions about the experience of collective investment scheme ("CIS") operators and investors that have taken this approach. While regulators in the United States have, to this point, not required funds to disclose an "all-in" transaction cost, either separately or as part of the fund's fee table, regulators in the EU are seeking disclosure of this information, with the specifics still to be determined.

1. United States

The SEC staff in 2003⁵ recognized the fundamental tension with disclosure of "all" trading costs, stating that "Although proposals to quantify transaction costs are attractive in theory, it is difficult to see how they could be feasible...[because] the resulting estimates of transaction costs would appear to lack the attributes of uniformity, reliability and verifiability that are the hallmarks for recording operations results in financial statements." In our comments on the SEC's work, we agreed that quantitative identification of "all" trading costs is problematic. While some trading cost components can be quantified easily and precisely, others can be quantified only with great difficulty, using one of a variety of estimation methods.⁶

As concluded by SEC staff, "additional numerical disclosure of trading costs would result either in a number that would be comparable and verifiable, but incomplete, or a number that would be complete but not comparable because it would be based on estimates and assumptions that would vary fund to fund." We have agreed with such observations and conclusions⁷ because, among other reasons, there is no single agreed-upon measure of transaction costs,⁸ existing measures have significant limitations and possible bias,⁹ and the operational burdens and costs would be

⁵ See Memorandum from Paul F. Roye, Director – Division of Investment Management, Securities and Exchange Commission, to William H. Donaldson, Chairman, Securities and Exchange Commission, dated June 11, 2003.

⁶ Commission costs can be easily determined, but spread, market impact and opportunity costs can only be roughly estimated.

⁷ See Investment Company Institute letter from Amy B.R. Lancellotta to Jonathan G. Katz, dated February 23, 2004, available at <https://www.ici.org/pdf/17130.pdf> ("2004 Letter").

⁸ Market participants, academics and other utilize various different measures of transaction costs. Although various quantitative tools are used in an attempt to estimate transaction costs, there is no single generally-accepted method or product that has been developed to capture all the necessary and relevant data from a fund and generate an objective and consistent measurement.

⁹ Several of the methods that have been considered over the years would include some, but not all, of the components of transaction costs, thereby presenting an incomplete picture of these costs to investors. In addition, the manner in which a trader executes an order may also bias transaction cost measurements under certain methods, such as when a trader

significant.¹⁰

Similarly, concerns have been expressed about including transaction costs in the expense ratio and fee table.¹¹

2. European Union

In the context of PRIIPs and MiFID II, the disclosure of charges and transaction costs with respect to investment products currently is being revised. The PRIIPs Key Information Document (“KID”), which will apply to UCITS, will require a disclosure format that is more comprehensive than that which is in the current UCITS KIID, and will include transaction costs in some form. How transaction costs are defined and accounted for is being consulted on at a highly technical level at this time and the questions being asked by the regulators reflect the difficulty of effectuating improved disclosure of costs, including transaction costs.¹²

Therefore, although current activities of the EU and the U.S. regulators regarding the disclosure of transaction costs differ, the issues with which regulators and stakeholders struggle, and the concerns that are raised, are the same and continue to be challenging.

B. Disclosure of Brokerage Commissions Paid

As an alternative to a single number for transaction costs, others have considered disclosure of certain items – such as actual brokerage commissions and portfolio turnover rate – as a way of providing useful and meaningful information to investors. Brokerage commissions paid by a fund

fills a large order in multiple parts or when a trader pursues momentum or contrarian trading strategies. Because of these limitations, several of the measures that have been considered are open to being “gamed” and therefore could encourage the execution of transactions in a manner that is intended to minimize transaction costs, potentially at the expense of what may be the best overall trade for a fund.

¹⁰ Calculating an all-in transaction cost would place a significant burden on funds in terms of recordkeeping and operational requirements. While certain fund advisers may have systems in place already that capture the relevant information, or have the capacity to implement such systems without significant difficulty, others – particularly small and medium sized firms – may lack the ability to do without significant burden and cost.

¹¹ Requiring commissions and/or other transaction costs to be included in the expense ratio and fee table presents concerns since, in contrast to the typical expense components in a U.S. mutual fund’s expense ratio, transaction costs tend to vary from year-to-year. Consequently, their effect on future costs and returns is uncertain. This volatility, which would not necessarily reflect changes in the cost of providing fund services to investors, could create confusion with respect to future fund expenses. *See* 2004 Letter.

¹² In February 2015, The Investment Association released a position paper on disclosure of costs and charges that includes eight specific principles of disclosure, including for collective investment schemes. The principles reflect the myriad of factors that must be considered in evaluating what, exactly, should be included as part of transaction costs and precisely how such costs should be disclosed. These principles are very nuanced, in particular providing that (i) charges figures should be distinguishable from transaction costs, (ii) the distinction between forward-looking and historic disclosures should be recognized, (iii) the distinction between quantifiable explicit costs and indicative implicit costs should be recognized, and (iv) intangible costs, such as market impact costs, should not be a standardized disclosure requirement.

are measured directly and could contribute to an investor's overall ability to evaluate and compare fund brokerage costs (*i.e.*, backward-looking information on the fund's return and expenses). In the United States, for example, all mutual funds (with the exception of money market funds) must disclose in their statement of additional information the actual dollar amount of brokerage commissions that they have paid during their three most recent fiscal years.¹³

C. Portfolio Turnover Rate

Portfolio turnover rate, while not a perfect proxy for fund trading costs, is generally viewed as being highly correlated with transaction costs and therefore helpful to investors. It can be easily calculated by funds, and is generally understood by investors and is comparable among funds. For example, as part of disclosure reforms, the SEC adopted a requirement in 2009 for U.S. mutual funds, other than a money market funds, to disclose the fund's portfolio turnover rate for the most recent fiscal year as a percentage of the average value of its portfolio, accompanied by a brief explanation of the effect of portfolio turnover (including adverse tax consequences) on transaction costs and fund performance.¹⁴ In the adopting release, the SEC recognized that portfolio turnover rate is an imperfect measure of portfolio transaction costs, but concluded that in the absence of a basis for prescribing a better measure, portfolio turnover rate, is an appropriate indicator of transaction costs.¹⁵

D. Conclusion

Given the challenges and the fact that regulators and market participants have appreciated these issues differently, IOSCO's proposed statements of good practice represent the right approach because they provide regulators with the ability to determine the most appropriate transaction cost disclosure regime – based on the facts and circumstances in that jurisdiction. We also believe that it is additionally important to recognize that the impact of all fund transaction costs *is already* reflected in a fund's total return.¹⁶

¹³ See Item 3 of Form N-1A, available at

<https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0CB4QFjAAahUKFwj3dyWmvfHAhUMVh4KHVn4BR8&url=https%3A%2F%2Fwww.sec.gov%2Fabout%2Fforms%2Fformn-1a.pdf&usg=AFQjCNFqk5Q0pcqSQ-wzEC0mDMXz7WhFwg&sig2=LNhEowYFrxUvgS4PLoQ6A>.

¹⁴ See Instruction 5 to Item 3 of Form N-1A. In addition, portfolio turnover rate for each of the past five years was already required in the Statement of Additional Information by Item 13(a) of Form N-1A.

¹⁵ See SEC Release No. 33-8998, at 38.

¹⁶ For example, in the U.S., the performance information included in the risk/return summary fee table and in fund performance advertisements is calculated pursuant to a formula prescribed by the SEC, which requires that it be net of all fees and expenses. As a result, when investors view this data, they are indirectly taking a fund's fees and expenses, including transaction costs, into account.

III. Soft Commissions – Managing Conflicts of Interest and Disclosure (Questions 14-15)

We support the standards of good practice relating to soft commissions proposed by IOSCO with respect to the management of conflicts of interest and disclosure of dealing arrangements (paragraphs 89 and 94). In Question 14, IOSCO asks about the mitigation of conflicts of interest and other measures that may be taken to ensure that investors' interests aren't adversely affected when dealing with soft commissions. In Question 15, IOSCO asks about the types of disclosures that are most useful to the board of directors of a CIS, and/or investors in a CIS.

As mentioned by IOSCO in the Consultation, whether to continue to allow the use of soft commissions to acquire research goods and services has been one of the key regulatory issues in the EU, and particularly the United Kingdom, over the past few years. In contrast, in the United States, there is a well-established regime, including a statutory "safe-harbor," permitting the use of soft dollars to acquire investment research. There is no active proposal in the U.S. related to soft commissions; nor are we aware of reviews of this issue taking place in jurisdictions other than the EU.

In the EU under MiFID II, the use of soft commissions to acquire research is being scrutinized, with the potential that the changes to soft commissions and investment research ultimately adopted in MiFID II will be extended to UCITS management companies and alternative investment fund managers. The UK Financial Conduct Authority ("FCA"), likewise, has been focused on soft commissions and has already taken measures to reform certain elements of the use of soft commissions – such as prohibiting payment for corporate access out of soft commissions – and has consulted on the impacts of further restrictions.¹⁷ Central to the work of both the European Commission and the FCA are concerns about inducements and conflicts of interest, and the worry that investment firms may be acting in a manner that is not in the best interests of their clients.

ICI Global has worked closely with member firms from around the world to understand how soft commissions are currently used to acquire investment research and the policies and practices that are in place to mitigate conflicts of interest and protect investors' interests. We have engaged heavily in analyzing the regulatory changes contemplated under MiFID and by the FCA.¹⁸ As we expressed in our responses to the 2014 FCA consultation and the European Securities and Markets Authority's ("ESMA") consultation on MiFID II, we support efforts to ensure that investment managers put customers' interests first and seek to control costs to customers to the extent possible. However, we strongly disagree with regulatory efforts that would require fully

¹⁷ In its 2014 consultation, the FCA asked for feedback on the potential impact of unbundling payments for research from execution arrangements based on the MiFID proposal (ESMA proposed advice) and also on the costs and benefits of extending the proposed MiFID requirements of unbundling to cover all research good and services.

¹⁸ Our response to the ESMA's consultation on the implementation of MiFID II is available at https://www.google.com/url?sa=t&ret=j&q=&esrc=s&source=web&cd=1&ved=0CB0QFjAAahUKEwj28IfcmYHIAhWTPB4KHectC28&url=https%3A%2F%2Fwww.iciglobal.org%2Fpdf%2F28294.pdf&usq=AFQjCNERMa63G5_0FMnh9KLY5N_z0thJQ&sig2=A1f3-mWq8_ZE5g1c49yEHA&cbvm=bv.102829193.d.dmo and our response to the 2014 FCA consultation on use of dealing commissions is available at <https://www.iciglobal.org/pdf/28448.pdf>.

unbundling payments for research from execution arrangements, particularly if such changes are made only in certain jurisdictions.

We believe such an approach would have significant negative consequences that would disproportionately harm the provision of research, small and medium-sized issuers, small or niche research providers. Further, if such unbundling is required only in one market, global investment firms will be unable to continue to operate global research and trading platforms that leverage scale and efficiency. Lastly, when there is a change to the regulation of soft commissions of the magnitude contemplated by ESMA and the FCA, such a change should be undertaken only after a comprehensive impact analysis with thorough consideration of the benefits and consequences of the proposed changes.

We recognize that the regulation of dealing commission and investment research in the European Union may change significantly. Nevertheless, we continue to believe, as expressed in our letters, that the current regime in the EU and elsewhere for the provision of research on a bundled basis has benefits and that the bundled brokerage model can continue to provide an effective and efficient way of providing access to execution and research services at a competitive rate if it is combined with appropriate oversight and controls, such as:

- i. Regular review of the type and value of research paid for with dealing commission.
- ii. Adoption of research budgets or other mechanisms to monitor the amount of dealing commission spent on research. These should be set at suitable frequency, typically not less than once a year. Clear controls should be in place to determine how and when any such research budgets or other mechanisms are altered.
- iii. Separation of trading and investment functions (*i.e.*, the trading desk should focus on seeking best execution when dealing with brokers, and the research portion of the commissions should be guided by the investment staff utilizing the research).
- iv. Commission sharing agreements (“CSAs”), which eliminate the need to direct trades to a particular broker in order to pay for research from that broker. CSAs allow the buy-side to recognize brokers who produce good research, without being under any obligation to recognize them by directing trades to them.
- v. Commission recapture arrangements to claw back commissions once budgets are reached.
- vi. Creation of a committee that sets broad policy direction, and reviews decisions of working groups.
- vii. Reports to clients on the use of commissions to assist clients in understanding client commission practices.

Mr. Ben Salem
September 22, 2015
Page 8 of 8

If you have any questions about our comments or would like additional information, please contact Susan Olson, Chief Counsel (1-202-326-5813 or solson@ici.org) or Eva Mykolenko, Associate Chief Counsel – Securities Regulation (1-202-326-5837 or emykolenko@ici.org).

Sincerely,

/s/ Dan Waters

Dan Waters
Managing Director
ICI Global
+44-207-961-0831