

Asset Management Market Study

Final Report

Market Study

MS15/2.3

June 2017



This relates to

In this final report we set out our final findings of the Asset Management Market Study

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1 Executive summary

The wider context of this study

- 1.1** The asset management industry plays a vital role in the UK's economy. Asset managers manage the savings and pensions of millions of people, making decisions for them that will affect their financial wellbeing. Asset managers generate returns for their clients by investing clients' money in a wide variety of UK and international enterprises. More broadly, by directing funding to firms they think are most likely to grow, asset managers support businesses that provide jobs and drive economic growth. Asset managers also have an important role in the corporate governance of the businesses they fund.
- 1.2** The UK's asset management industry is the second largest in the world, managing around £6.9 trillion of assets. Over £1 trillion is managed for UK retail (individual) investors and £3 trillion on behalf of UK pension funds and other institutional investors. The industry also manages around £2.7 trillion for overseas clients.
- 1.3** The services offered to investors involve searching for return, risk management and administration. The investor bears virtually all the investment risk. Over three quarters of UK households are saving for, or receiving, occupational or personal pensions that rely on these services, whether directly or indirectly. This includes over 9 million people saving for their retirement through defined contribution (DC) pension schemes and approximately 1.4 million savers currently building up pensions in defined benefit (DB) pension schemes.¹ There are also around 11 million savers with investment products such as stocks and shares ISAs. These investors are willing to put their money at risk to generate potentially greater returns than they can get through cash savings.
- 1.4** We launched our market study into asset management in November 2015. We looked at this sector because we want to ensure that the market works well and the investment products consumers use offer value for money. Improvements in value for money could have a significant impact on pension and saving pots.
- 1.5** In November 2016, we published the interim report of our Asset Management Market Study. The report considered how asset managers compete to deliver value for both retail and institutional investors. Our interim report found that evidence suggested that there is weak price competition in a number of areas of the asset management industry.
- 1.6** We consulted widely on our interim findings and proposed remedies. We received 153 written responses and held discussions with almost 200 stakeholders from 135 organisations through a series of round tables and one-to-one meetings. Following the interim report, we also undertook further work, both on areas highlighted in the interim report and in response to the feedback we received.

¹ The DB figure excludes approximately 5m deferred members of private DB schemes and several million building up benefits in funded (and unfunded) public sector schemes.



- 1.7** One point raised in the feedback, which we want to address, was a perception that our interim findings suggested that passive funds were preferable to active funds. This is not the case. Rather than focusing on one strategy over another, we think it is important that investors understand both the total cost of investing and the objectives of the fund or mandate they are investing in, so that they can choose the product that best meets their needs.
- 1.8** In light of the feedback received and the additional analysis undertaken, we have reached a final set of findings, which we set out below. These final findings are broadly consistent with the findings set out in the interim report.

Final findings

Price competition

- 1.9** We find **weak price competition in a number of areas of the asset management industry**. Firms do not typically compete on price, particularly for retail active asset management services. We carried out additional work on the pricing of segregated mandates which are typically sold to larger institutional investors. This showed that prices tend to fall as the size of the mandate increases. These lower prices do not seem to be available for equivalently sized retail funds.
- 1.10** We confirm our interim finding that there is considerable price clustering on the asset management charge for retail funds, and active charges have remained broadly stable over the last 10 years. We agree with respondents who said that, in and of themselves, price clustering and broadly stable prices do not necessarily mean that prices are above their competitive level. However, we also found high levels of profitability, with average profit margins of 36% for the firms we sampled. Firms' own evidence to us also suggested they do not typically lower prices to win new business. These factors combined indicate that price competition is not working as effectively as it could be.
- ### Performance
- 1.11** We looked at fund performance, and the relationship between price and performance. In our additional analysis, we found substantial variation in performance, both across asset classes and within them. However, our evidence suggests that, on average, both actively managed and passively managed funds did not outperform their own benchmarks after fees. This finding applies for both retail and institutional investors.
- 1.12** We looked at whether some investors, when choosing between active funds may choose to invest in funds with higher charges in the expectation of achieving higher future returns. However, our additional analysis suggests that there is **no clear relationship between charges and the gross performance of retail active funds in the UK**. There is some evidence of a negative relationship between net returns and charges. This suggests that when choosing between active funds investors paying higher prices for funds, on average, achieve worse performance. Similar academic studies of the US mutual fund industry have typically found a negative relationship between fund charges and fund performance.
- 1.13** It is widely accepted that past performance is not a good guide to future performance. We find that it is difficult for investors to identify outperforming funds. This is in part because it is often difficult for investors to interpret and compare past performance information. Even if investors are able to identify funds that have performed well in the

past, this past performance is not likely to be a good indicator of future performance. There is little evidence of persistence in outperformance in academic literature, and where performance persistence has been identified, it is persistently poor performance.

- 1.14** We found some evidence of persistent poor performance of funds. However, we also noted that **worse performing funds were more likely to be closed or merged** into better performing funds. In our additional work, we found that the performance of the merging poorer performing funds improves after they have been merged. However, we also found that the performance of the recipient fund, on average, deteriorates slightly after the merger, although it is not clear that this is a direct result of the merger. While mergers and closures may improve outcomes for some investors, not all persistently poorer performing funds are merged or closed. It can also take a long time for worse performing funds to be closed or merged.

Clarity of objectives and charges

- 1.15** We have **concerns about how asset managers communicate their objectives** to clients, in particular how useful they are for retail investors. We find that many active funds offer similar exposure to passive funds, but some charge significantly more for this. We estimate that there is around £109bn in 'active' funds that closely mirror the market which are significantly more expensive than passive funds.
- 1.16** We consider value for money for asset management products typically to be some form of risk-adjusted net return. This can be broken down into performance achieved, the risk taken on to achieve it and the price paid for the investment management services. **Investors' awareness and focus on charges is mixed and often poor.** There are a significant number of retail investors who are not aware they are paying charges for their asset management services. However, we have found that many institutional investors and some retail investors are increasingly focused on charges.

Investment consulting and other intermediaries

- 1.17** We find significant differences in both the behaviour and outcomes of different institutional investors. A number of, typically, large institutional investors are able to negotiate very effectively and get good value for money. However, we also see a long tail of smaller institutional investors, typically pension funds, who find it harder to negotiate with asset managers. These clients generally **rely more on investment consultants** when making decisions.
- 1.18** We have identified **concerns in the investment consulting market.** These include the relatively high and stable market shares for the three largest providers, a weak demand side, relatively low switching levels and conflicts of interest.
- 1.19** More generally, we recognise that asset managers play a role alongside others in the chain that delivers investment products to consumers. Our analysis suggests that **retail investors do not appear to benefit from economies of scale when pooling their money together** through direct – to – consumer platforms. We also have concerns about the value retail intermediaries provide.

Package of remedies

- 1.20** The feedback we received from respondents helped us refine our thinking about how to address the concerns we identified. As a result, we are proposing an overall package



of remedies to make competition work better in this market, and protect those least able to actively engage with their asset manager. We consider that this will increase efficiency, lead to the UK asset management industry being a more attractive place for investors and so improve the relative competitiveness of the UK market.

1.21 Our overall package of remedies is designed to bring together a consistent and coherent framework of interventions. We recognise that some investors are not well placed to find better value. Because of this, we are strengthening the duty on asset managers to act in the best interests of investors and are seeking to provide greater protection for investors. The remedies package also seeks to enable those investors who are able to, to exert greater competitive pressure on asset managers. It will increase the transparency of costs so that those seeking information can get it. We are also working towards providing greater clarity of fund objectives and performance reporting. Finally, the package seeks to improve how effective intermediaries are for both retail and institutional investors.

1.22 We recognise that there are a number of recent and forthcoming regulatory changes which will affect asset managers, and the remedies we have proposed sit within this wider policy context. These include Markets in Financial Instruments Directive (MiFID) II, Packaged Retail and Insurance-based Investment Products (PRIIPs) and the Senior Managers and Certification Regime (SM&CR). In considering the most appropriate remedies, we have thought about whether the concerns we have identified will be addressed by these regulatory changes. Where we believe that forthcoming regulations will at least partly address our concerns, we are looking at ways in which we can complement these changes. Our remedy package is designed to support and complement these initiatives. In some areas we are aware that there is likely to be further clarification at a European level, and we intend to consult on related proposals in light of this.

Remedies which provide protections for investors who are not well placed to find better value for money:

1.23 We propose to **strengthen the duty on fund managers to act in the best interests of investors** through clarifying our expectations around value for money, **increasing accountability through the SM&CR** and **introducing a minimum level of independence** in governance structures.

1.24 We are consulting on **requiring fund managers to return any risk-free box profits to the fund** and disclose box management practices to investors.

1.25 We want to make it easier for fund managers to **switch investors to cheaper share classes** and are seeking views on whether we should consider introducing a phased-in sunset clause for trail commissions.

Remedies which will drive competitive pressure on asset managers:

1.26 We continue to **support the disclosure of a single all-in fee to investors** and MiFID II will introduce this for investors using intermediaries. This will include the asset management charge and an estimate of transaction charges. We are testing ways to improve the effectiveness of forthcoming disclosure and will consult on any proposals later in the year.

1.27 We also **support consistent and standardised disclosure of costs and charges to institutional investors**. We recommend that both industry and investor representatives agree a standardised template of costs and charges and we propose to ask an independent person to convene a group of relevant stakeholders to

develop this further. Following this, we will work with these stakeholders to consider whether any other actions are necessary to ensure that institutional investors get the information they need to make effective decisions.

1.28 We will chair a working group to **consider how to make objectives clearer and more useful for investors**, before considering any subsequent rule changes. We intend to consult on requiring managers to be clear about why or why not a benchmark has been used and requiring that their use or otherwise of benchmarks is consistent across marketing materials. We also propose to consult to clarify that where managers present past performance they must do so against the most ambitious target held out to investors.

1.29 We are recommending that the Department for Work and Pensions (DWP) continue to review and, where possible, **remove barriers to pension scheme consolidation**. This should help those schemes who wish to benefit from economies of scale that might be achieved by such consolidation.

Proposals to improve the effectiveness of intermediaries

1.30 We consulted on making a market investigation reference to the Competition and Markets Authority (CMA) to further investigate the investment consultancy services.² The three largest investment consultants provided undertakings in lieu of the reference. We are proposing to **reject the undertakings in lieu** and are seeking views from other interested parties on this proposal. We expect to make a final decision on whether to make a market investigation reference to the CMA in September 2017.

1.31 We are recommending that the Treasury considers bringing **investment consultants into the regulatory perimeter**, subject to the outcome of the provisional market investigation reference to the CMA.

1.32 We have announced that we will be launching a **market study into investment platforms** to look at how competition is working in that market.

Measures of success

1.33 As part of Our Mission³, we explained the importance of undertaking evaluations after significant interventions. We also set out a framework for measuring the value we add through our activities. This includes measuring our own operational efficiency, measuring the impact of our interventions and measuring outcomes in markets.

1.34 Through our ongoing supervisory work, we will review the implementation of key remedies and assess the impact they have on firms' behaviour and outcomes across the market. In addition, our sector views present a high level overview of how the market is evolving.

1.35 We may also undertake a more detailed review of the impact of our interventions once they have had time to establish themselves. This may look at the impact interventions have had on the competitive dynamics of the market, through looking at changes in

² Investment consultancy services' is defined in paragraphs 5.2-5.4 of the terms of reference in our published provisional decision to make a market investigation reference www.fca.org.uk/publication/market-studies/ms15-2-2-a-mir.pdf

³ www.fca.org.uk/publications/corporate-documents/our-mission



investor outcomes such as price paid or net performance, or the effects on investor behaviour, fund flows and the effectiveness of governance.

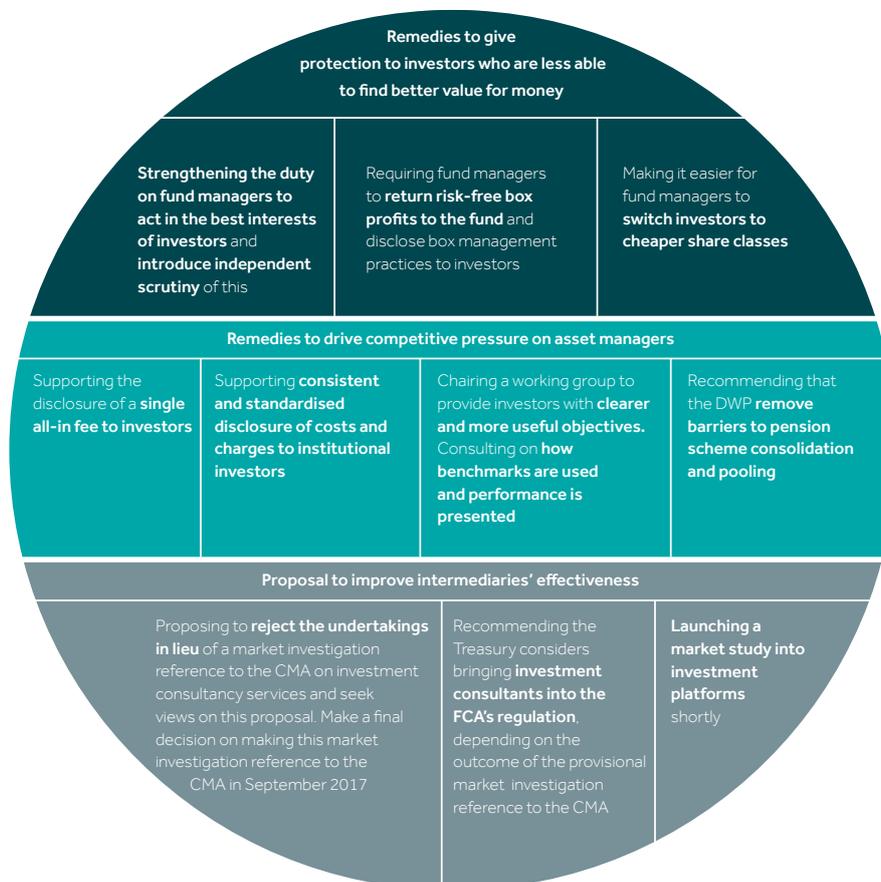
Next steps

- 1.36** Alongside this final report, we have published a consultation paper on some of the remedies.
- 1.37** Our overall package of remedies can be split into three groups:
- Remedies which we are consulting on alongside this report. This report sets out our overall proposals and the accompanying CP17/18 and our letter to the UIL parties set out the relevant detail and questions for stakeholders on our proposals aimed at:
 - strengthening the duty on fund managers to act in the best interests of investors
 - requiring fund managers to return any risk-free box profits to the fund
 - facilitating switching investors to cheaper share classes
 - proposing to reject the undertakings in lieu of a market investigation reference
 - Final remedies which do not require further consultation:
 - recommendation that the Treasury considers bringing investment consultants into the regulatory perimeter
 - recommendation to DWP to remove barriers to pension scheme consolidation and pooling
 - recommendation to both industry and investor representatives to agree a standardised disclosure of costs and charges to institutional investors, asking an independent chair to convene relevant stakeholders to develop this further and working with stakeholders to consider whether any other actions are necessary.
 - launching a market study into investment platforms shortly
 - Remedies for which we give our initial views on these proposals in this document and plan to publish relevant detailed consultations at a later stage:
 - costs and charges disclosure to retail investors to be consulted on later this year
 - benchmarks and performance reporting to be consulted on later this year
 - convening a working group on objectives and consulting on any rule changes at a later stage, subject to the outcome of the working group.
- 1.38** In addition to publishing further consultations later in the year, we will publish our decision on whether to refer the market for investment consultancy services to the CMA.

2 Overview of our remedies package

- 2.1** We proposed a package of remedies in the interim report which included a range of options to address the concerns we identified. As for all market studies, we have had regard to a range of remedy options. These include using rule-making powers and publishing guidance, supervisory action and formal investigations by our Enforcement Division as well as giving the industry an opportunity to develop measures that address our concerns and improve client outcomes.
- 2.2** The feedback we received on both our findings and our remedy proposals was helpful to refine our thinking on both our individual proposals and the overall package. Our remedies are intended to work together supporting and reinforcing one another to achieve a cohesive package. We intend that the remedies, by acting together, will make competition work better in the market, as well as protecting those least able to actively engage with their asset manager.
- 2.3** Due to the timing of European legislation, and related work being undertaken at European level, which will affect some of the areas in which we identified issues, we will be approaching the consultation on and implementation of our remedies in phases. Please see CP17/18 for remedies that we are consulting on alongside this report. These relate to governance, box management and share class switching. Where remedies do not require further consultation they are set out in this document. We plan to consult on most of the remaining remedies later in the year.
- 2.4** As we noted in the interim report, we have considered the impact our proposed remedies will have on the attractiveness of the UK as a place to do business and will continue to do so with the final package of remedies. Although we recognise that the proposed package of remedies will probably increase costs for some firms, we expect that the benefits will outweigh any costs. We also expect that any improvements to outcomes for investors will lead to the UK asset management industry being a more attractive place to invest and therefore improve the relative competitiveness of the UK market.
- 2.5** We recognise that there are a number of recent and forthcoming regulatory changes which will affect asset managers and the remedies we have proposed sit within this wider policy context. These include MiFID II, PRIIPs and the SM&CR. In considering the most appropriate remedies, we have thought about whether the concerns we have identified will be addressed by these regulatory changes. Where we believe that forthcoming regulations will at least partly address our concerns we are taking these into account and we are considering our scope for addressing our specific concerns as effectively as possible. Our remedy package is designed to support and complement these initiatives. Where our interventions are impacted by potential clarifications of the detail of upcoming regulatory initiatives at European level we intend to consult on related proposals in the light of that work.
- 2.6** This section summarises our remedy proposals at a high level and explains briefly how they fit with the other remedies in our package. More detail of each remedy is provided in the relevant sections of Part B of this document.

Our package of remedies



Governance

2.7 We are consulting on proposals to:

- clarify expectations around value for money
- ensure transparency of actions that governance bodies take to satisfy their consideration of value for money
- introduce independence in governance structures

2.8 We are consulting on these proposals for Authorised Fund Managers (AFMs) alongside this document where we also consider the degree to which these rules should apply to other similar investment products. For further information please refer to CP17/18.

2.9 We are also setting out our intention to introduce a new Prescribed Responsibility under the SM&CR⁴ to act in the best interests of investors including a consideration of value for money.⁵

4 A set list of responsibilities under our and the PRA's rules that must be allocated to firms' Senior Managers with the intention to ensure that every part of a firm's business or activities has a Senior Manager with overall responsibility for it. The SM&CR is an accountability framework.

5 We will formally consult on the introduction of the new prescribed responsibility as part of the wider consultation on the roll out of the SM&CR regime later this year.

Objectives, benchmarks and performance reporting

Objectives and benchmarks

- 2.10** We are exploring options to improve the language used in, and clarity of, objectives to make them more useful for retail investors. We will chair a working group on this issue, and will make sure that the consumer perspective is firmly represented alongside that of the industry. We will consider whether the working group's output should be turned into new rules on how objectives should be written.
- 2.11** Following consideration, we do not think that all funds should have to use a specific benchmark, comparator or numerical target return, whether in their objectives or otherwise. However, we intend to consult on an approach so that an AFM that chooses not to set a benchmark, comparator or numerical target return for a fund must, firstly, explain its reasons for so doing to investors and, secondly, is prevented from using any other benchmark, comparator or target in marketing. In addition, we intend to consult on requiring those managers that do use a benchmark, comparator or numerical target return to explain their reasons for doing so and to use it consistently across regulatory and marketing materials.
- 2.12** For further information on our current thinking please refer to Chapter 12.

Past performance presentation by Authorised Fund Managers

- 2.13** We continue to work on the remedy proposals in this area. We are considering introducing rules and/or guidance to clarify that where AFMs present their past performance, they must do so against the most ambitious target they set out to investors. We also intend to consult on rules such that where an AFM does not set a specific benchmark, comparator or numerical target return for a fund the AFM must not present the fund's past performance against any benchmark, comparator or target. We will also continue to consider how past performance disclosure and communication at other points in the consumer journey may affect consumer decision-making and outcomes.
- 2.14** We intend that any future proposals on clarity of objectives and the use of benchmarks and comparators, along with increasing transparency of cost and charges will enable investors to better understand what their fund is trying to achieve, and monitor performance against any targets. These combined will better equip investors to understand instances of persistent underperformance.
- 2.15** For further information on our current thinking please refer to Chapter 12.

Transparency of fees and charges

Fees and charges communications

- 2.16** There are significant changes coming in through MiFID II and PRIIPs which will affect the way that charges are communicated to investors including the MiFID II proposal which will require the disclosure of a single all-in fee to investors using intermediaries. This will include the asset management charge, an estimate of transaction costs and any intermediary fees.
- 2.17** While we consider that this will provide investors with greater clarity about the charges they are likely to face, we think that the way in which this information is presented to



investors will have an impact on how this is used. Therefore we are testing ways to improve the effectiveness of any forthcoming disclosure in order to understand the role of the prominence and formatting of charges information in encouraging investors to focus on the impact charges have on their investments and enabling effective price comparison. This will inform the development of any future remedies in this area.

2.18 We intend to consult on our proposals on fees and charges communications later in the year. For further information on our current thinking please refer to Chapter 13.

Institutional disclosure

2.19 We support consistent and standardised disclosure of costs and charges to institutional investors.

2.20 Any template should be free of jargon, accessible and easy to understand. We consider that the purpose of a standardised disclosure template would be to provide institutional investors with a clear understanding of the costs and charges for a given fund or mandate. This should allow investors to compare charges between providers and give them a clear expectation of the disclosure they can expect.

2.21 We recommend that both industry and investor representatives agree a standardised template of costs and charges and we propose to ask an independent person to convene a group of industry and investor representatives to develop this further. We will work with these stakeholders to consider whether any other actions are necessary to ensure that any templates meet the needs of institutional investors and address our concerns. For further information on our current thinking please refer to Chapter 13.

Trustee disclosure

2.22 We do not propose to require trustees to publicly disclose all cost and charges information.

2.23 Section 44 of the Pensions Act 2014 will place a duty on us and the DWP to require the disclosure and publication of information about transaction costs in defined contribution workplace pensions. We will, in due course, consider the legal measures needed to meet the duties.⁶

Other remedy proposals

Box management practices

2.24 We are consulting on proposals to require firms to return any risk-free box profits to the fund and to disclose box management practices to investors.⁷ We are proposing that:

- AFMs must pass risk-free box profits back to the fund

⁶ www.fca.org.uk/publication/consultation/cp16-30.pdf

⁷ In dual priced funds the bid-offer spread between prices to buy and sell the fund reflects the costs of buying and selling the underlying securities needed to create or cancel units. This means that when customers enter or exit the fund, the costs of their transactions do not dilute the value of existing unitholders' units. Where there are buyers and sellers of the fund on the same day, buy and sell orders can be matched with each other without incurring the transaction costs priced into the bid-offer spread. This is because existing units can be transferred from selling to the buying customer without any need to buy and sell the underlying securities. The transfer can be completed by passing all of the dealing of the units through the 'manager's box'. Some asset managers take the resulting money from the spread itself which the client has already 'paid' but will not be 'spent' transacting in the market. The asset managers' capital is never at risk in this process as matching is instantaneous.

- AFMs approach to box management must be disclosed in the fund prospectus

2.25 We are consulting on these proposals alongside this document see CP17/18.

Share class switching

2.26 We are consulting on proposals to facilitate switching investors to better value share classes. We are proposing to modify our guidance to clarify that when dealing with unresponsive unitholders the AFM can undertake a mandatory conversion if the following conditions are met:

- the power to undertake a mandatory conversion must be set out in the prospectus in line with COLL 4.2.5R 5(d)
- the AFM must have made all reasonable attempts to contact unitholders
- the AFM is satisfied on reasonable grounds that the change will not result in detriment to investors

2.27 We intend that these changes will remove the barriers we heard were making it difficult for asset managers to switch investors into new, better value share classes.

2.28 We are consulting on these proposals alongside this document see CP17/18.

Pension pooling

2.29 We are recommending that DWP continues to review, and where possible, remove barriers to pension scheme consolidation and pooling. We believe that some schemes will be able to benefit from pooling assets, though we have found some barriers to doing this. We are therefore hoping to minimise these where possible.

2.30 For further information on our current thinking please refer to Chapter 15.

Ongoing work on retail and institutional intermediaries

Platforms

2.31 Respondents have confirmed our view that further work is warranted to assess the significance and scope of the issues raised. As a result, we will be launching the Investment Platforms Market Study. The study will consider how investment platforms and firms offering similar services in adjacent markets compete to win new customers and retain existing customers.

2.32 Further information will be released shortly in our Investment Platforms Market Study Terms of Reference document.

Investment consultants

2.33 We considered that competition was being adversely affected in the institutional advice market by a weak demand side, persistent levels of concentration, high barriers to entry and vertically integrated business models. We consulted on making a market investigation reference to the CMA to further investigate the investment consultancy services. The three largest investment consultants provided undertakings in lieu (UIL) of the reference, which offer commitments to disclose charges and performance



information in a standardised format, alongside changes to address conflicts of interest and strengthen their internal processes.

- 2.34** Whilst we welcome the UIL proposals submitted, we have provisionally concluded that we cannot be confident that the UIL would provide as comprehensive a solution as is 'reasonable and practicable' in addressing the features we have identified which may prevent, restrict or distort competition in the investment consultancy services. See Chapter 15.
- 2.35** We have written to the firms indicating that we are proposing to reject these and are seeking views from other interested parties on this proposal.⁸ We expect to make a final decision on whether to make a market investigation to the CMA in September 2017.
- 2.36** We are recommending that the Treasury considers bringing investment consultancy services into the regulatory perimeter. We do not currently regulate the asset allocation advice provided by investment consultants and employee benefit consultants. This means we are not able to set performance standards or assessment criteria for this advice. We also have limited authority to ask industry to develop ways to measure and assess advice themselves.

Ongoing compliance with competition law

- 2.37** Our engagement process during the market study has indicated a possible lack of awareness of competition law in some areas of the sector, in particular as to how the law applies to commercial relationships and interactions with one another. We remind firms of the importance of ensuring their business activities are undertaken in compliance with competition law.⁹

⁸ Please send views to assetmanagementmarketstudy@fca.org.uk.

⁹ See www.bankofengland.co.uk/markets/Documents/femrjun15.pdf for further guidance on the application of competition law to wholesale markets

3 Next steps

- 3.1** We have now completed the market study phase of this work. However, we will continue to discuss the remaining elements of our proposed package of remedies with stakeholders.
- 3.2** Any new rules and guidance will be subject to cost benefit analysis and formal consultation. We have published a consultation paper alongside this report, which includes our remedy proposals on governance, share class switching and box management. The closing date for responses to these consultations is 28 September 2017.
- 3.3** We are also seeking views on our proposal to reject the UIL alongside this report. The closing date for responses is 26 July 2017. We expect to publish our decision on whether or not to make a market investigation reference to the CMA in September 2017.
- 3.4** We have also begun work on behavioural trials for disclosure. We are currently prioritising what we would like to test based on consultation responses, existing and forthcoming policy, and other research in this area. We will use the findings of these trials to inform the design of our remedies.
- 3.5** We expect to publish further consultation papers on most of the remaining remedies in the package before the end of 2017.
- 3.6** Once our remedies have been implemented we will keep them under review to monitor whether they are having the effect we desired.

Part A: Final findings

Feedback on interim findings, our response and additional analysis

Many respondents agreed with the key findings we presented in our interim report. Where we have received additional information from respondents these comments have not changed our overall conclusions.

- Neither active and passive funds outperform their benchmarks after costs. We found examples of poor value for money products in both active and passive strategies.
- The conclusions we drew on both retail and institutional investor behaviour remain unchanged.
- We continue to believe that price clustering, when combined with our understanding of how firms set prices, the profitability analysis, and the absence of relationship to performance, demonstrates that price competition is weak for actively managed products. We have identified issues in both retail and institutional intermediaries and believe further work is merited.
- We found mixed evidence on cost control in this market.

The additional analysis we undertook after the interim report does not materially change our overall conclusions.

In the interim report, we set out analysis aimed at helping us understand how asset managers compete. In Part A we give an overview of the feedback we have received against each of the main topics we analysed. Part A also outlines the additional analysis we had either planned at interim report stage, or have carried out based on the responses we received. Against each set of responses we also explain how these have informed our view of our analysis. For detailed technical feedback and our responses to these, please see Annex 1.

This chapter includes sections covering the analysis we undertook to answer the following questions:

How do investors choose between asset managers?

- How do intermediaries and fund governance bodies affect competition between asset managers?
- What do prices, performance and profitability tell us about how competition is working?
- Are asset managers willing and able to control costs along the value chain?
- Are there barriers to entry, innovation and technological advances?



We have set out analysis and responses relating to investment consultants in Chapter 10 of this report. We also include a section for feedback on other topics raised by respondents.

For more information about our proposed remedies please refer to Part B of this report.

4 How do investors choose between asset managers?

4.1 We looked at how investors choose between asset managers. At interim review stage we found that:

- Investors typically consider value for money to be some form of risk-adjusted net returns.
- Investors are not always readily presented with a choice of passive funds through platforms and rating providers.
- When choosing products and providers, past performance, reputation and charges matter. Institutional investors are more sensitive to price than retail investors.
- Past performance information is difficult to interpret and compare and does not appear to help when trying to identify future outperformance.
- Tools available to assist both retail and institutional investors in identifying outperforming products, such as best buy lists and investment consultant recommendations, do not allow investors to identify products that on average, after charges, outperformed the stated benchmark.
- It is important that both retail and institutional investors take information about charges into account when choosing and monitoring investment products. This is because charges are a drag on performance and reduce the net returns investors receive.
- Switching is fairly infrequent. There are no major barriers to switching but investors find it hard to judge whether and when it is best to switch.
- Institutional investor scale and expertise matter in terms of how effectively oversight bodies negotiate. There is scope for consolidation to improve how effective oversight is, particularly among smaller trust-based pension schemes.

Market dynamics and efficiency

4.2 Some respondents claimed that the asset management industry is competitive because there is low concentration, a wide range of available products and asset classes, and that more recent reductions in fund holding periods was consistent with low barriers to switching.¹⁰

4.3 Several respondents felt that asset managers differentiate themselves based on value and quality of service. Other respondents felt that active managers do not compete on fees, but on investment philosophy and strategy instead.

¹⁰ In this context it is the amount of time between when the fund was bought and sold.

- 4.4** Several respondents argued that we had not sufficiently acknowledged the strong growth of passive investments. They argued that the growth of passive investments places competitive pressure on active managers.
- 4.5** Respondents noted that active management makes important social contributions which are not fulfilled by passive management, including:
- Supporting price formation, which benefits indices and passive funds. They stated that price formation further ensures efficient allocation of capital, leading to economic growth.
 - Contributing to corporate governance and stewardship.
 - As a significant net exporter, they benefit the UK economy.
- 4.6** These respondents warned of the risks of excessive passive management, which include:
- Over-valuation of assets which are highly weighted by the indices. Conversely there may be an under-valuation of assets assigned a low weight or not readily covered by indices. They argued that this may result in reduced innovation and competition.
 - Price-setting that is increasingly determined by hedge funds with short-term returns horizons, leading to larger divergences between prices and long-term values.
- 4.7** Other comments and recommendations included:
- The focus of competition in active management should shift from short-term return against benchmark to stewardship. Respondents argued that this can be achieved by asset managers disclosing their stewardship and corporate governance activities.
 - We should ensure fair competition between different business models and empower investors to make choices, and not favour one business model over another.
 - We did not appear to acknowledge the contributions of active management beyond delivering returns for investors. Some noted that the pursuit of value for money appeared to be our only concern, which could undermine the economic functions of active management.

Market dynamics and efficiency – our response

We agree that there are many providers of asset management services and a wide range of available products and asset classes.¹¹ We have also seen some consolidation in the industry, and some industry commentators have suggested that this is likely to be a trend. A large or small number of competitors do not necessarily mean that there is effective or ineffective competition. We note that we do not think that asset management is a particularly concentrated market, although there are some asset classes or strategies that are more concentrated than others.

¹¹ Although we note there may be some types of investments where the market is more concentrated.



We recognise that there is price competition for some asset management products, but we found that this is likely to be limited in the active segment. We note that asset managers compete on other factors, though we have identified issues with the clarity of objectives. We also found that it is hard for asset managers to signal future delivery of returns.

We have seen that the proportion of total assets under management (AUM) held in index tracking funds has increased since 2008. We also note that this growth has occurred at the same time that charges for passive funds have fallen on average. By contrast, charges for active funds have remained broadly constant on average over this time period. If passive growth had led to a substantial increase in competition among active managers, we could have expected active prices to have fallen. So, there is currently insufficient evidence to conclude that the growth in passive products has led to a material increase in competition faced by active managers. Nonetheless, we acknowledge that passive management has the potential to increase competitive pressure on active managers.

We agree that active management plays an important role in accurately pricing assets in a well-functioning market. Accurate pricing of assets in turn allows both equity and debt capital to be efficiently allocated to the firms that would generate the greatest economic returns to society. Active management can also affect firm behaviour by exercising shareholder rights. These are important economic functions of active management.

We also recognise that passive styles seek to replicate the returns of the market index as opposed to stock picking and therefore do not contribute to the accurate pricing of assets by construction. However, passive management can and does provide stewardship to the businesses it invests in.¹² We understand concerns around the potential impact that an increasing share of passive investment can have on pricing stability and whether prices accurately reflect assets' underlying value. A number of these concerns have been raised publically in the context of the US market, which has a higher percentage of passive than the UK.¹³ We continue to monitor the market dynamics between active and passive management.

The purpose of this market study is not to identify and encourage one investment strategy over another. It is to examine whether the asset management industry is functioning well, whether investors can identify the investment products most suitable for their needs, and whether those products offer appropriate value given their costs, regardless of the specific investment strategy. As we discussed in paragraph 4.10 of the interim report, different investment strategies can cater for investors with different investment objectives. We have taken different approaches to assessing the value for money achieved by different broad strategies, such as active management, passive management, or absolute return strategies. This allows for their different investment

12 COBS 2.23R requires firms to disclose the nature of their commitment to the Financial Reporting Council's Stewardship Code, or their alternative investment strategy. Most major UK passive managers are signatories to the Stewardship Code.

13 Various sources estimate that passive management represents approximately 30% of the market in the US whereas in the UK it is closer to 20%.

objectives and enables us to identify nuanced issues specific to each strategy. We do not favour any particular investment strategy over another, and think it is important that investors consider which product or strategy best meets their needs, including taking into account the objectives of the fund, the price they will pay and the risk that is being taken on.

Fund flows

- 4.8** Some respondents suggested there is a stronger correlation between performance and fund flows, in both directions, than our interim report presented. In particular, these respondents argued that underperformance leads to significant outflows. They suggest that this is driven by intermediaries reacting to fund performance and directing the investment flow of retail investors.
- 4.9** Some respondents argued that there are a wide range of drivers of fund flows, and our interim report had not reflected them all.

Fund flows – our response

Our interim report aimed to understand whether specific measurable factors were drivers of fund flows and, if so, whether these were useful predictors of fund performance in the UK. We accept that there are a wide range of factors that affect flows between funds. However, many of the other potential drivers of fund flows mentioned by respondents are not quantifiable. As a result we have not assessed all possible drivers. We note that for the institutional segment, several 'soft' drivers of flows mentioned by respondents would be captured indirectly in our analysis through investment consultant ratings.

We have undertaken further analysis on the link between performance and fund flows. This analysis confirms the finding in the interim report that there is a strong link between past performance and fund flows. This demonstrates that some investors react to aspects of fund performance, by moving money between rival investment products in response to changes in performance. In particular, good performance is rewarded with net inflows of funds. However, in the interim report we found that past performance is not a good indicator of future risk-adjusted net returns.¹⁴

While poor performance sees fund outflows, we have also found evidence of persistent poor performance. This suggests that not all investors react to sustained periods of relatively poor performance by switching to a rival investment product. For further information please refer to Annex 2.

14 See paragraphs 6.46-6.50 of the interim report

Value for money

- 4.10** Many respondents noted that value for money cannot simply be measured by net returns against a benchmark. They said it must also take account of a range of other factors such as volatility, stewardship, and whether a product meets specific liabilities or objectives.
- 4.11** Many respondents also pointed out that value for money is highly subjective. They argued that each investor will seek out products that satisfy their own view of value for money. Encouraging investors to focus on charges alone may lead investors to purchase products that are not suited to their investment objectives.
- 4.12** Several respondents said that the asset management industry was not delivering value for money. They cited 'closet trackers', high profitability and management fees which are set in relation to other asset managers' prices rather than the value added by the specific asset manager.
- 4.13** Some respondents called for us to express and codify qualitative and quantitative factors of value for money. Others called for the industry to better explain the value they offer by explaining their objectives more clearly.

Value for money – our response

We accept that no single measure of value for money will capture the circumstances of every retail and institutional investor. Overall, the research presented in the interim report suggests that the most likely single measure of value for money from an individual investor perspective is a form of risk-adjusted net return.

At an industry level, we consider that profitability represents a useful indicator of overall value for money. The persistently high levels of profit earned by asset management firms suggest that prices lie above competitive levels, which in turn indicates that on average investors may not be achieving value for money. Put another way, the profitability analysis suggests that of the gross performance delivered by asset managers, a greater amount is taken by managers in the form of annual management charges (AMC) than would be taken in a more competitive marketplace.

At the individual investor level, industry participants often examine net returns against a benchmark as a measure of value for money. In these cases the benchmark can act as a proxy for the risk element. We recognise that a comparison of net return against a benchmark is not always the most appropriate measure of value for every product, as noted by respondents.

The analysis in the interim report used net returns against a benchmark to assess value for money from an investor perspective. Based on responses received since the interim report, we have additionally presented returns split by asset class so that we are able to ignore products which are not suited to an assessment against a benchmark. We have considered performance further in Chapter 6.

We received a specific comment that absolute return funds should not be included in an examination of returns against a benchmark. We note that in the interim report we treated these funds separately (see paragraph 6.64 of the interim report). Our findings at the interim report stage were based on funds that as of September 2016, had reported 24 months of rolling performance. There were 74 absolute return funds that had reported 24 months of rolling performance. Of these, 6 funds had reported negative performance for 20 or more months over the last 24 month rolling period. In addition, 27 funds in the sample reported negative rolling performance for 12 or more months. While the performance data of this sector over a 24 month rolling period may not be representative of its long-term performance, these numbers suggest that customers can face a relatively high likelihood of negative performance.

Financial capability

- 4.14** Many respondents said retail investors have a low level of financial literacy and understanding of the relevant products. Most respondents suggested that, as financial education is not the direct responsibility of the asset management sector, we should be working with the Government and the wider financial services industry on this.
- 4.15** Some respondents felt that the interim report did not sufficiently address the issue of financial education.
- 4.16** Respondents articulated their understanding of our aims to be empowering consumers, achieving the objectives of the study and leading to a more competitive market place. Some said that greater information provision by firms or regulators would not be enough to achieve these aims as retail investors need to improve their understanding of financial matters and increase their level of financial literacy and capability before more information alone would be effective.
- 4.17** Respondents also raised concerns about the lack of standardisation of language or methodology when communicating performance or costs to investors. They argue this makes it difficult for investors to understand asset management products.

Financial capability – our response

We agree that investor education is important. However, financial education is unlikely to be the only solution to the concerns identified. Improving financial literacy in the UK could bring benefits, but concerns about clarity of objectives, complexity of performance reporting and a lack of cost transparency all make it difficult for even well engaged and informed consumers to make effective decisions. We therefore think that it is important to improve the clarity and accuracy of what is being sold and any reporting so investors are better able to compare products. Please see Chapter 12 for our proposals on objectives and performance. For investors who are unable to assess these effectively, we consider that strengthening the requirements on governance bodies will help to deliver better outcomes.



Any improvements to financial education may have longer term effects, but we have identified issues that we need to address now and therefore are making proposals to make the delivery of information available to consumers.

As a couple of respondents acknowledged, financial capability and education is outside our remit. We continue to liaise with those organisations that are best placed to work on these issues including, for example, the Money Advice Service, the Treasury and the Department for Education.

Consumer research on retail investors

4.18 Many respondents agreed with our finding that retail investors do not focus sufficiently on charges. However, many respondents raised a number of issues about the consumer research:

- Whether we can generalise research findings on unadvised investors more broadly to all retail investors.
- Whether the small sample size of 40 unadvised investors in the qualitative research produces informative findings. Respondents warned about the danger of making important policy decisions based on the findings from a small sample. Some suggested we should conduct further qualitative research with a larger sample.
- The apparent contradiction between the findings that 77% looked at charges when they made their investment, 45% said charges were influential in their investment choice and 51% stated that they do not pay fund charges or that they are not sure whether they pay fund charges.
- Our finding that a lack of switching indicates that some investors do not readily switch away from funds offering poor value for money. Respondents argued that this could be due to investors having long-term investment horizons. Respondents also noted that holding periods have reduced, suggesting that investors are switching more readily. Other respondents agreed that switching may not lead to better outcomes.
- A respondent suggested that more money is invested in cheaper share classes, which they saw as evidence that investors are price sensitive.

Consumer research – our response

We used both qualitative and quantitative techniques in our consumer research. We recognise that we used a relatively small sample of 40 participants in the qualitative research, and we noted the potential for self-selection bias in the interim report. The main purpose of this phase of the research was to inform and guide the larger scale, quantitative research that followed. The sample selection was not intended to be statistically representative of unadvised retail investors, but to reflect the

range of unadvised retail investors in the market. We therefore consider the sample size suitable for the purpose of the qualitative research.

We also found that the qualitative findings (based on 40 interviewees) were broadly consistent with the quantitative findings (based on a larger sample of 2,500 respondents which is representative of the population of non-advised retail investors), and provided discussion in the interim report where our findings differ between the two research phases.

On the question of whether investors take charges into account, our interim report acknowledged that the evidence is mixed. We found that 55% of survey respondents looked at fund charges when they made their most recent investment.¹⁵ When respondents were later asked whether they paid fund charges, only 49% stated that they pay fund charges (with another 22% stating 'not sure'). We consider these findings to be broadly consistent with each other. We did some additional analysis outside the market study on platforms and the findings are similar as we found that few investors sufficiently engage with charges.

We agree that the research findings for non-advised retail investors may not directly apply to advised retail investors. In our remedy design process, we will consider the impact of any proposed remedy on advised and non-advised retail investors, and will consult on any proposals.

We remain satisfied that the findings in our interim report reflect investor awareness and knowledge about fund switching, and the inclination of investors to do so. A significant number of non-advised retail investors appear to continue to face some perceived barriers to switching.

Platforms – clickstream data

We performed additional analysis outside the market study, looking at the investor journey on a platform, and the findings are broadly consistent with our initial findings. Our previous analysis as part of the interim report suggested that a significant number of investors did not focus on charges when making investment decisions.

We worked with a firm to obtain six days' worth of data on visits to their online investment platform. This rich dataset contained millions of customer visits, showing the pages people visited and in what order, as they used the website. We also obtained data on the investments they made and their holdings at the end of that month.

We used the data to quantify how much customers focus on charges when they make online investment decisions, as well as characterising some other broad patterns of behaviour.¹⁶

15 We asked 'Did you look at any of the charges when you made your investment' and 77% of respondents answered 'Yes'. Of those that answered 'Yes' we further asked 'Which charges did you look at when you make your investment' and 72% answered 'Ongoing fund charges'.

16 The data tells us what page a customer is looking at but not what they look at on that page, so we have to make some assumptions, based on what charge information is present on the page and how prominent it is. These results are indicative only: they are based on 6 days of data and we make no causal analysis – we cannot say what has caused the observed behaviour.



Engagement with charges

Overall, we find that customers rarely engage¹⁷ with charges associated with fund investment.

- Of all the visits to the website to look at funds, fewer than 9% looked at charges. Under 3% look at documents (including the KID).
- On average, when customers engage with charges, they do so for longer than when they also look on other pages. They spend just over 60 seconds on charge-related pages and 43 seconds on non-charge related pages per visit.
- A strong indicator of engagement with charges is when customers sort lists of funds by charge, which would show that they wish to minimise charges. Customers only do this during 0.1% of visits.
- Customers are slightly more likely to engage with charges towards the end of a visit rather than at the start.
- As a percentage of time spent across all customers, the majority of time was on the account and portfolio summaries (about 25%) and factsheet landing pages (over 10%).
- Those who buy passive funds tend to have higher engagement with fees. Out of all visits where clients buy funds, 17% engage with fees. Out of visits where clients buy passive funds, 21% engage with fees.

Typical paths through the website

We identified three 'typical paths' that customers took as they used the website. They are based on the route that clients take to get to fund factsheet landing pages and indicate the way that they look for and buy funds.

1. 'Reviewers' – These are customers who mostly go to the website to check their existing investments. They start in their portfolio summary and then go and look at funds.
2. 'Choosers' – These are customers that use recommendation lists to navigate to the factsheet landing page.
3. 'Searchers' – These are customers that use keyword searches internally from the website or externally from search engines in order to find funds.

The likelihood of viewing charges differs depending on the typical path a customer takes through the website. Overall, we find that customers who engage with charges tend to buy cheaper funds.

- 'Choosers' and 'searchers' pay more attention to charge information than 'reviewers' and are more likely to buy funds than 'reviewers'. They make up 18 and 19% of (fund related) visits respectively.
- 'Choosers' and 'searchers' also tend to buy cheaper funds.¹⁸
- Of the 'choosers', those who choose from the Index tracker list are most likely to view platform charges.
- Although very few customers sort by fees, those who do tend to buy cheaper funds.

17 Engagement with charges is defined as visiting pages which predominantly contain charge information. We don't include the fund landing page in this definition, as it contains lots of information besides charges and is the first page that a customer will be routed to when looking at a fund, so isn't a good indicator of active engagement with charges.

18 For choosers this is partly because they are more likely to buy funds recommended by the firm, which are generally cheaper, but across the board they buy cheaper funds.

As the data is taken from just six days, we can't say whether behaviour is a characteristic of the customer generally, or just their behaviour at the time. However, it indicates that customers who engage with charges do take them into account in their purchase decisions and tend to minimise them.

Institutional investors

- 4.19** Responses suggested that the focus of our assessment of institutional investors was too narrow and could have focused more on investors other than pension trustees while other responses pointed to the small sample size as a weakness of our evidence. They suggested that this may have led us to understate the level of switching in the investment consultant market.
- 4.20** More generally, respondents agreed that there are weaknesses in the pension trustee segment of the market and an undue focus on manager selection is a key issue which should be addressed. A number of respondents suggested that trustees, given their limited time and resources, should spend more time focusing on their investment strategy and overall risk management and asset allocation.
- 4.21** Respondents agreed that trustees rely on investment consultants. They do this, firstly, because they are often required to take advice, particularly where they do not have the expertise and, secondly, because they are potentially liable if things go wrong. However some respondents felt that our interim report focused unduly on this.
- 4.22** Some respondents felt that we had drawn unsuitable comparisons between fund manager selection and scheme selection. These respondents were of the view that the incentive structures of the defined contribution (DC) market further differ from the incentives present more generally in scheme selection. Respondents reported that this was due to factors such as fee constraints and risk-aversion due to the potential for legal action against the employer if they choose default options which result in bad outcomes in the future.
- 4.23** Respondents generally agreed that the issues we had identified at the interim report stage in pension trustee decision-making reflected their own experience. This, for example, included support for the idea that larger pension schemes were more likely to have greater resources to assess quality than smaller schemes. However respondents did note that different trustee groups' experiences varied.

Institutional investors – our response

We believe the greater focus on pension schemes in our analysis was appropriate. This is due to the size and structure of the pensions market and the greater likelihood of competition issues compared to other areas of the institutional market.

We acknowledge the limitations of the institutional investor survey and we highlighted this in the accompanying annex of our interim report. However we think the results from the survey, combined with other pieces of evidence, create a reliable view of the issues institutional



investors may face. For example, during our institutional roundtables we heard mixed views from trustees on the levels of empowerment they felt. Where respondents raised concerns about specific figures taken from the survey we have sought to take further evidence into account. For example, we have used data provided by investment consultants to review the level of switching between consultants. We found further evidence that a large proportion of institutional investors did not switch providers over a five year period as at least 74% of clients did not leave their provider in this time.¹⁹

We have not collected data that would provide evidence that trustees spend less time on asset allocation than other factors but note that this feedback has come up numerous times throughout the study from a range of parties. The Pensions Regulator has recently published guidance for trustees which covers this, including a suggested order of investment decisions from those most likely to impact future outcomes to those least likely to do so.²⁰

We continue to agree that DC schemes may be risk-averse and this could have an effect on investment selections they make and the outcomes scheme members achieve.

We recognise that outcomes vary by trustee group and, while we have drawn conclusions based on our analysis and discussions with firms, we agree that not all investors will face the same challenges. Some trustees are very effective buyers, though there are a large number of smaller schemes who may encounter issues when negotiating. We also accept that while size can be a determinant of outcomes, it is not the sole factor. Small schemes with good levels of expertise and good governance structures can achieve relatively good outcomes. For further information please refer to Chapter 15.

¹⁹ This is discussed further in chapter 10.

²⁰ www.thepensionsregulator.gov.uk/guidance/db-investment-one-governance.aspx

5 How do retail intermediaries affect competition between asset managers?

5.1 We considered the role of intermediaries and the extent to which they act in the investor's interests. At interim review stage we found that:

- Retail platforms can secure discounts on fund charges but this practice did not appear to be widespread. It is not clear that retail investors benefit fully from the potential buyer power available to platforms.
- Investors can be charged a range of different platform fees, potentially making it difficult to understand the full cost of investment.
- Platforms represent an important route to market for new funds and managers, and perform useful due diligence.
- Within the advice market, we identified concerns about the impact of increasing vertical integration of advice and fund management in some firms, the growth of model portfolios and the role of third party rating providers on competition and value for money.

5.2 In this section we have included the discussion on the relevant findings in the retail market. We have considered the role of investment consultants in Chapter 10.

Advisers, value chain and vertical integration

5.3 A large number of respondents said we needed to consider the entire value chain when assessing the asset management industry, and value for money in particular. This is largely because they consider that:

- holistic evaluation and solutions are better than a piecemeal approach
- advice costs are often claimed to be one of the largest portions of the asset management value chain

5.4 A number of respondents also had concerns about conflicts of interest in vertically integrated firms. For example, one respondent argued that vertical integration has increased since the RDR and that in their opinion this could be interpreted as providers seeking alternative routes to regain their influence on the retail market.

5.5 Some respondents had concerns about model portfolios and outcome-focused products. The main issues raised were:

- poor value for money, including extra fees for limited additional value
- potentially higher tax liabilities if investors use a model portfolio



- poor transparency

5.6 While our interim report did not look at how financial advisers shape choices, we referred to research which suggested that partially advised investors are much less likely to invest in passive funds compared to non-advised investors.²¹ We received mixed responses on the types of funds that advisers were recommending. Some respondents argued that advisers are increasingly recommending passive funds, but that this trend is not necessarily in the client's best interest. By contrast, others argued that the market structure still favours active funds.

5.7 One respondent argued that asset managers continue to charge registration fees to investors, despite the fact that this work is now not predominantly done by them.

Advisers, value chain and vertical integration – our response

Some of these issues will be covered in our market study into investment platforms. The study will explore how 'direct to consumer' and intermediated investment platforms compete to win new and retain existing customers. The study will explore whether platforms enable retail investors to access investment products that offer value for money. The Investment Platforms Market Study will allow us to understand the causes of any competition problems in this market and assess what we can do to improve competition between platforms and improve consumer outcomes.

The financial advice industry continues to be one of our priorities and we will continue to monitor and act on any risks to our objectives in this area. As part of our work implementing the Financial Advice Market Review recommendations, the FCA and the Treasury have been working together to develop indicators to provide an overview of the market for advice and establish a baseline to help monitor developments in the market. The work considers issues from both supply and demand side perspectives and will be published on the FCA's website in Q3 2017.

Fund ratings

5.8 Several ratings agencies responded to our interim report. They acknowledged that there are conflicts within some of their business models, but argued that they manage these effectively. Other respondents were more concerned that conflicts distort the effectiveness of ratings, and therefore consumer choice and outcomes. The lack of negative ratings was cited as evidence that the ratings are biased. Some felt that the visibility of passive funds and fund coverage more generally could be increased by ratings agencies to the potential benefit of consumers.

²¹ Platform consumer research – referenced in paragraph 4.21 of the interim report www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

- 5.9** To ensure fund ratings work in the interests of consumers, some respondents called for the fund ratings industry to be regulated. There were calls for specific interventions in the market, such as RDR type rules preventing payments from asset managers to fund ratings companies.
- 5.10** In the interim report we outlined our findings on whether best buy lists add value by helping consumers identify funds that perform better than those which are not on a best buy list. Some fund rating providers questioned the evidence we used for the interim report and cited internal research which they said proves the value of their ratings.
- 5.11** Respondents suggested that we conduct further work on the following areas:
- conflicts of interest in the business models of ratings providers
 - clarity on the purpose of ratings and their subsequent performance
 - ratings of passive funds
 - fund coverage by ratings companies
 - for advised investments, the lack of alignment between who benefits from ratings and who pays for them

Fund ratings – our response

We agree that fund ratings can have an impact on how investors choose products and they are likely to play an important role in competition for asset management products. They can also have a positive effect on competition where any conflicts are managed effectively.

As part of the Investment Platforms Market Study we will assess the extent to which platforms are dependent on third party fund rating firms and how platforms ensure any conflicts of interest do not affect the quality of information they make available to investors and financial advisers. We will consider if further action is needed as a result of this.

Since the interim report we have done further analysis of the value of certain ratings providers. This analysis uses additional data provided by some firms in our data sample (see Annex 1). The further work does not change our overall conclusion that ratings and best buy lists can on average help investors identify funds that outperform funds not on best buy lists. However, our analysis shows that over our assessment period ratings and best buy lists did not on average identify funds that outperformed their Morningstar category benchmarks.

We received a comment that the interim report's analysis of the predictive value of the Morningstar Analyst Rating, a forward-looking assessment of funds, was based on a limited historical data set. We consider that the data set used for this analysis (8 years of data) was a sufficiently long time period to evaluate the predictive value of these ratings using our default methodology. We recognise that when we ran



sensitivities which assume investors hold funds for 3 or 5 years, our sample size for this rating system reduced substantially. Following the interim report, we were provided with a full history of the Morningstar Analyst Rating, dating back to 2002. We have re-run our analysis using the longer data set and find that Gold-, Silver- or Bronze-rated funds outperformed not-rated (or neutral-rated) funds. This finding applies when we considered this over different holding periods including one-month and five-years. However, Gold-, Silver- or Bronze-rated funds did not outperform their Morningstar category benchmarks.

6 What do prices, performance and profitability tell us about how competition is working?

- 6.1** We looked at outcomes for investors and asset managers in terms of performance, price and profitability.
- 6.2** On pricing, at interim review stage we found that:
- There is evidence of price clustering for active funds for sale in the UK. Prices paid by institutional investors in segregated mandates are often discounted and so there is less price clustering.
 - Charges for active funds have remained stable over time. By contrast, charges for passive funds have been falling in recent years.
 - There is little evidence that firms compete on the basis of price, particularly for active products.
 - Some investors may choose to invest in funds with higher charges because they expect to achieve higher future returns. However, recent academic and Morningstar research from the US suggests that higher charging funds are not on average generating higher performance, compared to cheaper funds in the same investment category. Our initial analysis indicates that there is no clear link between price and performance.
- 6.3** On performance, at interim report stage we found that:
- Institutional active investment products, on average, outperformed their benchmarks before charges were deducted. After charges there was no significant return over the benchmark for institutional products.
 - Active funds for sale in the UK, on average, outperformed benchmarks before charges were deducted, but underperformed benchmarks after charges on an annualised basis by around 60 basis points (bps).
 - There is little evidence of persistent outperformance in the academic literature, but there is some evidence of persistent underperformance. Our analysis provides some evidence of persistence of relatively poor performance. However, we have also found that asset managers are more likely to close or merge worse-performing funds. Further analysis was required to determine whether fund mergers result in better outcomes for investors.
 - Some investors seek a target absolute return, rather than primarily seeking outperformance against a benchmark. However, the funds offering these styles of investment often provide misleading performance reporting to investors.
 - Passive funds, after costs, would generally underperform against the relevant market benchmark. The market index is a theoretical construct which does not take into account the costs of investing. A cheap passive fund which closely tracks the index



will have a low tracking difference and generate net returns close to the market benchmark.

- While passive funds are on average cheaper than active funds, around £6bn is invested in passive funds which are significantly more expensive than average.
- Some investors appear to be paying 'active' prices for products that are only partly active (i.e. products which are similar to passive products, but just take small positions either side of the benchmark). Many investors in expensive 'partly active' products would be likely to achieve greater value for money by switching to a cheaper passive fund in the same investment category.

6.4 On profitability, at interim review stage we found that:

- Average profit margins for our sample of firms are around 35% for the period 2010 to 2015. All the asset management firms in our analysis earn a return on the capital employed which is greater than our estimate of the cost of capital. When adjusting profitability to reflect that asset management firms' employees share in the profits of the firm through wages and bonuses, the estimated profitability of asset managers is even higher.

Pricing of active management products

- 6.5** Think tanks and interest groups generally agreed that price competition is weak in active asset management. However, firms and a trade body suggested that investors are able to assess value for money, respond to prices, and switch funds. They point out the growing AUM held in passive funds in the UK in recent years as evidence of investors switching to cheaper funds.
- 6.6** Respondents noted that price clustering does not necessarily mean a lack of competition in active management, as it may point to effective competition. They also argue that price competition appears to be working well between active and passive management. However, many of these respondents also noted that price competition could be encouraged if investors were better able to assess value for money.
- 6.7** Some respondents disagreed with our finding that the OCF for active funds has not changed significantly over time. They argued the analysis did not consider charges weighted by AUM, or post-RDR pricing trends. Some respondents provided alternative analyses of pricing trends, which they argued showed different results, such as a trend fall in prices over 2013-2015. Other respondents argued that prices have not fallen in line with yields in recent decades.
- 6.8** Some respondents argued that the differences between pricing of active and passive, and between different sectors, is due to factors such as cost bases, investment processes and technology. They argued, therefore, that price stability is not an appropriate measure to gauge competitiveness in the active management industry.

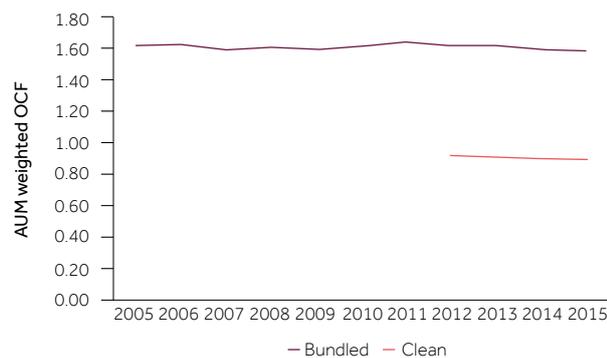
Pricing of active management products – our response

We acknowledge that price clustering on its own does not mean that competition is not working effectively, and that it could be present in markets where there is competition on price. However, when considered alongside other evidence, such as our findings on profitability, firms' pricing decisions and the absence of a clear relationship between prices and performance (see Annex 4), we take this to be an indicator that price competition is not working effectively.

Our interim report presented analysis of price clustering using the AMC and the OCF. We recognise that, while the price clustering was more pronounced when looking at the AMC, there still appeared to be certain price points for the OCF. This reflects the fact that the OCF contains charges levied on behalf of third parties.

We have considered the responses giving alternative analyses of pricing trends over time. Many of these analyses are limited in their value as they only consider a short time horizon, such as a three year period. The interim report presented money-weighted pricing trends over the 2005-2015 period, which we consider is a more meaningful period to assess pricing trends. Over this period the analysis showed that, for active funds, bundled OCF charges had fluctuated slightly around a fairly stable level of approximately 1.6%. Over the shorter, post-RDR period of 2013-2015, the interim report showed that 'clean' active share classes on average experienced relatively small price decreases.

Interim report Figure 6.14 (Page 112): Trends in the AUM weighted OCF for active share classes over time

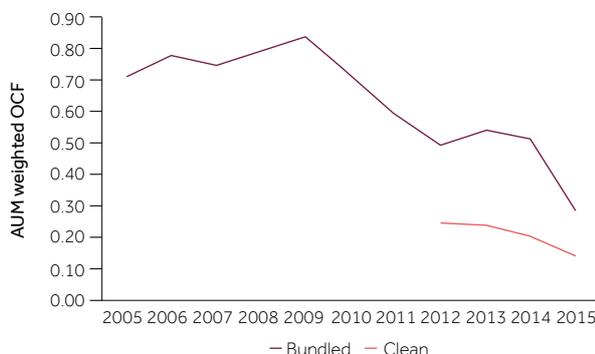


Source: OCF data and information about the fees structure of share classes from a sample of asset managers enriched with information from Morningstar direct. AUM data from Morning star Direct.

By contrast, the interim report found that both bundled and 'clean' passive funds saw substantial price falls over the same time periods.



Interim report Figure 1.4 (Page 13): Trends in the asset-weighted OCF for index-tracking share classes over time



Source: OCF data and information about the fees structure of share classes from a sample of asset managers enriched with information from Morningstar direct. AUM data from Morning star Direct.

Some respondents argued that price falls for 'clean' share classes over 2013-2015 reflected a sharpening of competition following RDR, and the increased take-up of passive funds. We accept that these developments could have caused prices to fall. Specifically, if industry developments had led to a substantive increase in competition for active managers, we would have expected active prices to have fallen materially and we have not seen this. Additionally in our view the 2013-2015 period is too short a sample to conclude that competition has improved significantly. Nonetheless, we acknowledge that industry developments have the potential to increase competitive pressure on active managers.

We note that the analysis in the interim report presented headline prices, rather than actual prices faced by investors. Our analysis of platform data suggests that the majority of funds were not discounted over the periods we examined in the interim report.

Segregated mandate pricing

The interim report showed our initial examination of prices faced by segregated mandates, and we have done some more work to examine this further. Using data requested from a sample of asset managers, we find that management charges faced by segregated mandates tend to be substantially lower than retail funds, even after controlling for size and asset class.

We examined whether the higher average prices faced by retail investors are explained by the higher costs of serving the retail segment. Analysis of the profitability data we collected shows that, while costs per AUM are higher in the retail segment than in the institutional segment, revenue per AUM is even higher for the retail segment. This suggests that margins earned by asset managers are higher for the retail segment, so higher costs do not fully explain the average pricing differentials between retail funds and segregated mandates. We note that the remaining differential could reflect differences in negotiating strength between mandates and funds, even after controlling for size.

We also find that the management charge for segregated mandates tends to fall as the size of the mandate increases. In addition, we find that the money-weighted average charge faced by mandates has been fairly constant over the 2006-2015 period.

For further information please refer to Annex 3.

Performance

- 6.9** Many respondents argued that the evidence in our report did not support our finding that 'active funds underperformed their benchmarks after charges'. They argued that overall the interim report presented mixed and inconclusive evidence on performance by various types of funds. Some respondents also argued the interim report was misleading as it failed to point out that passive funds also underperformed against benchmarks.
- 6.10** One respondent argued that, if, active performance on average matches the benchmark return net of fees, this would mean that active is on average outperforming passive. Another respondent also argued that some of the assumptions on which we relied for our theoretical description of the market do not hold in reality and therefore we should not suggest that on average passive would outperform active.
- 6.11** Respondents also proposed a number of adjustments to our fund performance analysis. The most common comments were that the final report should:
- incorporate risk into our assessment of performance
 - remove distribution costs from an assessment of the value added by asset managers
 - present performance results on a more granular basis because an average masks the fact that many sub-groups of asset managers and product types outperform
- 6.12** A number of asset managers also presented evidence to suggest that their own funds have outperformed their benchmarks, even if the industry on the whole has not.

Performance – our response

Based on the analysis undertaken in the interim report, a review of other studies, and our further work undertaken following feedback received to the interim report, our overall view remains that both active and passive funds have not on average historically outperformed benchmarks net of fees. This finding applies to retail and institutional investors.

We also find substantial variation in average historical performance both across asset classes and within asset classes. An average performance finding at an asset class level does not necessarily apply to all investment categories or strategies within that asset class, and does not necessarily apply to every fund or fund family operating in that asset class.

For further information please refer to Annex 1 & Annex 5.



Price and performance

Our interim report summarised results from studies of the US mutual funds industry which suggest that there is a negative relationship between the charges of a mutual fund and the performance of a fund manager. It also included our initial results from the UK retail active fund industry which suggested that there was no clear relationship between price and performance.

Following the interim report we have done further analysis of the relationship between the OCF of retail active funds in the UK and the performance generated, both gross and net of fees.

For the three equity categories we analysed, we found that the majority of funds cluster within a narrow price range but often deliver very different levels of return. Where there was price variation the majority of results showed no statistically significant correlation between price and performance.

We conclude that the weight of evidence suggests that there has been no clear relationship between the gross performance of retail active equity funds in the UK and the level of OCF in the period examined. We find some evidence that more expensive active funds underperformed cheaper active funds when considered net of fees.

For more detail on our work please see Annex 4.

Absolute return funds

- 6.13** Respondents broadly agreed with our analysis that there are problems in the way that firms explain absolute return funds. Respondents noted that it is potentially difficult to accurately and clearly explain the outcomes of an absolute return fund as they perceive difficulties in providing benchmarks against which performance can be measured easily.
- 6.14** Respondents raised concerns about elements of absolute return funds that may be difficult for investors to understand. These included the wide range of targets, the different measurement periods for targets, charges, the mix of asset classes underpinning the strategies, the use and lack of common definition of the term 'absolute return' and the differences between expectations and outcomes.
- 6.15** Several respondents asked us to do more work in this area. This included requests for us to investigate how prevalent specific performance targets are, how professional fund investors measure performance and whether performance outcomes were being achieved.

Absolute return funds – our response

We agree with respondents that absolute return funds can fulfil a role for investors. Absolute return funds also continue to be popular with investors.

We are still concerned with the way that absolute return funds, and particularly their performance, are understood by investors. We are concerned that many absolute return funds do not report their performance against the relevant target return. Performance for some

funds is shown against cash alone, despite, for example, having a 'cash + 2%' target. This could potentially be misleading investors about the real outperformance compared to expectations.

We also have concerns about AFMs of absolute return funds charging a performance fee when returns are lower than the relevant fund's most ambitious performance target. This leads to the manager being rewarded despite not achieving what the investor considers to be the target performance.

We also agree that the wide range of charges and targets could be confusing to retail investors, and is unlikely to help investors compare performance even within the absolute return sub-sector.

A respondent asked us to consider the outcomes of absolute return funds. We considered this at interim report stage²² and our analysis suggested that customers face a relatively high likelihood of negative performance. We also found that funds in this category can have high volatility, with some funds showing an annualised volatility greater than 10%.

Please refer to our remedies for objectives and performance disclosure in Chapter 12.

Partly active funds

- 6.16** Respondents generally shared our concerns that expensive partly active funds provide poor value for investors.
- 6.17** Respondents highlighted various concerns with our method to identify partly active funds, including that:
- the use of active share and tracking error are not accurate proxies for partly active funds
 - the risk of mistakenly labelling genuinely active funds as partly active
 - the advantages of active management not captured by an analysis of cost and tracking error
 - tracking error is not a determinant of future outcomes
- 6.18** Respondents suggested that concerns around partly active funds are best addressed through improved disclosure of fund objectives and costs. They cautioned against encouraging investors to consider only a fund's active share in their portfolio selection. They argue that where this is used it should be considered alongside other manager and firm metrics. One firm recommended that the industry convene a working group to design a simple disclosure to investors based on a basket of measures that reflect how much a fund is actively managed.

22 See page 110 paragraph 6.64

- 6.19** One asset management firm suggested that the availability of investment data combined with competitive pressure, have made partly active funds less commercially viable to provide. They believe that these funds will be driven out of the market without our intervention.

Partly active funds – our response

We welcome firms' agreement that expensive active funds which closely mirror the benchmark do not serve investors' interests well. We agree that there are various methods to determine how active a fund is, and that higher tracking error does not necessarily lead to higher returns and lower tracking error to lower returns. We agree that neither tracking error nor active share should be the sole basis to identify partly active funds. However we continue to be concerned that over £100bn is in funds that appear to closely follow the market but are charging 'active' prices.²³ We also continue to have concerns about how asset managers communicate the objectives and outcomes of these funds to investors.

We want investors to have sufficient information to be able to compare products and prices to find the right fund for them. If investors consider that a partly active fund represents the best balance of risk and return for them, they should be able to access this at a competitive price. If an investor wants a fund manager to be taking decisions that move their holdings further away from the benchmark, they should be able to identify which products offer this. We want to be sure that investors are clearer about what they are paying and what the fund is offering in return.

In addition, we consider that our remedy to strengthen fund governance, will encourage firms to consider whether those funds that closely replicate the market but charge high fees, deliver value for money.

For further information on our remedies on governance please see Chapter 11 and on objectives, benchmarks and performance see Chapter 12.

Profitability

- 6.20** Some respondents agreed that profitability was high in the asset management industry although others argued that high returns are required for establishing funds due to the set up risks. Some respondents felt the evidence we presented did not demonstrate high profitability and therefore we should not conclude that price competition is weak.
- 6.21** Some respondents felt that the sample time period was not long enough and that a longer time period would lower our estimate of profitability. They also felt the sample size was too small and that our choice of firms and use of money weighted averages

23 This estimate is based on tracking error.

meant we focused more on the profitability of large established firms. Respondents argued that these firms have higher margins and this skewed our analysis.

- 6.22** In terms of our methodology, respondents felt that profit margins cannot be compared between industries and therefore our finding of high margins was invalid. Respondents also argued that front line staff costs cannot be added back and that this materially distorts profitability.

Profitability – our response

Our time period excludes the financial crisis, largely because firms told us that they could not provide the information we had requested during that period. We undertook cross-checks using publicly available data for this period and consider our analysis to be robust.

We accept that our sample included larger sized firms and this was intended to avoid placing a disproportionate burden on smaller firms as we asked firms for a large amount of information. We also intended to achieve the greatest possible coverage of the whole market and focusing on the larger firms enabled us to do this. We estimate that our analysis covers just over half of the asset management market.²⁴ We recognise there could be variations between different sizes of firms and their profitability, however alternative analysis provided to us does not show a clear link between the size of the firm and profitability.

To estimate economic returns, we must make adjustments for both human capital and real economic profits. We still consider that the cost of asset manager salaries can be treated in a similar way to profit sharing from an economic standpoint and should be adjusted for in this analysis. Applying an uplift to capital without addressing economic profit is likely to understate the economic return on capital employed (ROCE), though such an approach still produces results which are on average above our cost of capital benchmark.

As an alternative, accounting data, without any adjustment, shows operating margins of 36% and ROCE between 20-45% across firms in our sample for the six years we analysed.

For further detail on our work on profitability please see Annex 1.

Economies of scale and pricing structures

- 6.23** Respondents commented on drivers of economies of scale at industry, fund and investor level. Respondents also noted that there can be benefits of economies of scale other than lower cost, including additional capabilities or access to more information, which can lead to better performance.



- 6.24** Respondents also noted the loss-making profile of some smaller funds. They agreed with our finding that at launch smaller funds are already passing on 'future' economies of scale, to some extent, by subsidising the OCF while the fund grows to be self-sustaining and profitable. Respondents also argued economies of scale diminish above a certain fund size.
- 6.25** Responses were less clear about whether economies of scale are passed to investors. Some respondents argued that managers were obliged to pass on some economies of scale and gave tiered pricing as an example of this.
- 6.26** Several respondents felt that firms could do more to pass on economies of scale through transparent tiered fee structures. However, others felt that both institutional and, through platforms, retail consumers can already access tiered pricing.
- 6.27** Others said they see significant potential unintended consequences in tiered pricing. A respondent said that tiered pricing could encourage investors to enter larger funds due to their lower fees. However, returns on larger funds could be reduced as the fund runs into capacity constraints. There was concern that the loss of return could be greater than the reduced fee structure and that the tiered pricing system could encourage consumers to invest in funds that offer poorer value for money.

Economies of scale and pricing structures – our response

Economies of scale can arise at the fund level or at the firm level, both of which may benefit the asset manager. The extent to which investors benefit depends on the extent to which any economies of scale are passed on from the manager to investors.

At a fund level, we have found that asset managers tend to benefit from economies of scale and these do not seem to be passed on fully to investors. We are therefore consulting on requiring governance bodies to consider the extent to which economies of scale have been passed on by the asset manager when they consider value for money. For further information please refer to CP17/18. We note that larger funds can experience diseconomies of scale but these tend to affect funds' capacity to invest, and so lead to lower returns to investors, rather than create higher costs for asset managers.²⁵

Whilst rising AUM leads to economies of scale for asset managers at a firm level, we agree that the number of funds and the number of clients often associated with a change in AUM can have some effect on the size of cost savings. For example, we were told cost savings for the manager from rising AUM would be greater if this is concentrated in one large fund rather than ten smaller funds.

As AUM grows the average cost of ancillary services can also fall, as fixed overheads are spread across more business. Larger asset managers can leverage their size to negotiate a share of these savings. We would expect this to be taken into account by governance bodies as part of their consideration of value for money.

²⁵ For further information please see, for example, page 93 of the interim report.

Retail platforms can secure discounts on fund charges but this practice is not widespread and, where this happens, the discounts are not generally very large. As noted in the interim report, it is not clear that retail investors benefit fully from the economies of scale available to platforms. We will consider this further as part of the Investment Platforms Market Study.



7 Are asset managers willing and able to control costs along the value chain?

7.1 We looked at how asset managers control costs and the quality of third party services they buy on behalf of the investors.

7.2 At interim stage we found that:

- Charges to third parties appointed by asset managers constitute around 20% of the total fund charges, although there is significant variance around this average.
- Third party charges are generally transparent to asset managers who, in turn, disclose them to investors. These are mainly clear and transparent, the exception being transaction costs. While the revenue taken by asset managers is disclosed as part of the OCF, we are concerned that risk-free box profits are opaque and are not passed through to investors.
- Procurement of some ancillary services appears broadly appropriate and effective.
- Asset managers appear to be poorer at controlling transaction costs, although we have observed some progress in this area.
- Asset managers are incentivised to control the quality of services by both reputational effects and regulation.
- Bundling of ancillary services is frequent but raises no significant competition concerns.
- There may be competition problems in some ancillary services markets, notably transfer agency, index and data provision, which limit asset managers' ability to control price and quality.

Cost control

7.3 There were mixed responses on our analysis and findings on this topic, although this was partly due to how respondents interpreted our findings.

7.4 Several asset managers agreed that transparency of charges could be improved for investors.

7.5 Several respondents said that the implication that managers do not control charges was inaccurate. Respondents generally agreed with the finding in our interim report that firms appear to be relatively good at controlling the cost of ancillary services where these are included as part of the OCF. Some respondents felt that charges were controlled whether or not they were part of the OCF as they affected fund performance.

- 7.6** Several respondents explained the differences between costs that can be controlled by the asset manager and those that cannot, such as stamp duty and some elements of transaction cost. Other respondents explained the differences between costs that are related to different functions undertaken by the manager, such as differences between transaction costs and other costs.
- 7.7** A depositary suggested we do further work in this area, particularly looking at the potential conflicts of interest inherent in and the effects of bundling services on smaller asset managers.
- 7.8** Several respondents have argued that Figure 1.2 in the interim report, which was an illustration showing the potential impact of the OCF and transaction costs on fund returns, double counted transaction costs.

Cost control – our response

Market participants told us that asset managers should and do have an incentive to control the costs and services they pay for as the costs will affect net performance. However, the evidence from our supervisory work is not so clear. On trading and execution costs, for example, we found that most firms do not have adequate management focus, front office business practices or supporting controls to meet our current requirements on best execution.²⁶ We have also found that firms can earn significant administration fees on top of the AMC. These total received fees can exceed the costs that the manager incurs, and we find that asset managers do not often reduce ad valorem administration fees, even as economies of scale are achieved.

We agree that our analysis on cost control did not cover, for example, small asset managers and we did not do a formal and detailed evidence gathering exercise as part of our analysis. As we acknowledged in our interim report specifically about our findings on bundling, smaller asset managers may have less buyer power, which may affect how they are able to purchase services.

Our analysis did not explicitly split out costs that cannot be controlled by the asset manager including stamp duty. Though we agree that we could further sub-categorise costs we do not think that this materially changes our position. We still consider that costs which are complex or costly for the asset manager to control or those which may be a revenue stream for the asset manager are not controlled as effectively as other costs.

For clarity, Figure 1.2 in the interim report was intended to be illustrative only and it was not intended to and did not contribute to our overall findings. We recognise that in this example, by using a gross return for the funds, transaction costs should already be captured within this. Therefore we accept that by deducting transaction costs in addition to the OCF, we double counted transaction costs for active and passive funds. Notwithstanding this illustration, both fees and transaction costs contribute to the total cost of the fund, and we have



considered transaction costs in more detail as part of our proposal for a single all-in fee in Chapter 13.

Data and index providers

- 7.9** Respondents agreed that there were issues in both data and index provision that we should consider further. They gave us examples of pricing structures and charging models that suggested competition was not working well for these services.
- 7.10** We have continued to hear issues including little choice or opportunity to switch to another index provider, even if quality is poor or prices too high. This happens for a variety of reasons, including that the relevant index is effectively a market standard and because it would require changes to internal systems.

Data and index providers – our response

We did not receive any responses which provided evidence that was not consistent with our interim findings on data provision. We continue to believe there may be issues with data provision in line with those we set out in the interim report.

We have considered the responses that provided further information on issues with index provision. These suggest that prices have increased for index provision, in some instances very significantly, despite no associated improvement in service level.

Therefore the responses we have received on index and data provision do not give us reason to believe that our original views should change.

8 Are there barriers to entry, innovation and technological advances?

8.1 We looked at product development and innovation in the asset management market. We also considered whether there are barriers to competition, particularly where they reduce the incentives or ability to innovate and introduce technological advances.

8.2 At interim stage we found that:

- There is some evidence of innovation, particularly in investment products and strategies. However, some of the developments we have seen are more likely to have an 'evolutionary' rather than 'revolutionary' effect on competition in the medium to long term.
- We do not see innovation in the ways active management firms charge for their services and we are interested in further exploring the reasons why.
- There is limited evidence of significant structural or regulatory barriers to entry in the asset management market.
- There are ways in which intermediaries and distributors can both encourage and act as a barrier to innovation in the market for some asset management products and services.

Barriers to entry and innovation

8.3 Several respondents commented on our analysis and findings on barriers to entry. Some felt that barriers were higher than we suggested and cited the general volume and complexity of regulation and the potential ramifications of EU withdrawal. A respondent agreed that incumbents do have an advantage when launching new funds.

8.4 A small number of respondents commented on the effects of investment consultants, expressing views that investment consultants had a minimal impact. This was despite other respondents noting that investment consultants' charging structure incentivises them to focus research on managers who are likely to receive positive recommendations, including larger asset managers.

8.5 Respondents noted that data protection rules were acting as a barrier to innovation in the use of cloud-based solutions. Respondents also noted that financial promotion rules stopped innovative social media solutions.

8.6 A data provider raised the 'per use' payment structure in place for benchmarks, and noted that this may act as a barrier to entry for smaller firms.²⁷

²⁷ Respondents described that data providers often charged a licence fee but then also fees each time an index was used elsewhere such as in a data centre or on distribution or marketing materials.



- 8.7** Some respondents felt that our interim report understated the amount of innovation in the asset management market. Respondents referred us to new strategies and new distribution techniques including 'robo-advice'.

Barriers to entry and innovation – our response

Since the publication of the interim report we have observed some entry and innovation in the market such as entry into the platform market and the introduction of new charging structures.

We agree that the general level of regulation and other macro-economic factors such as the UK's withdrawal from the European Union could create challenges and barriers to entry. Two of our five principles²⁸ that will guide our advice to Government on EU withdrawal are:

- cross-border market access – open markets are an important enabler of healthy competition, supporting our objectives
- consistent global standards – across regions and jurisdictions in order to minimise the risks of regulatory arbitrage

We still believe that consultants and rating providers can act as both an entry mechanism and a barrier for some funds.

It is worth noting that there are several ongoing initiatives looking at potential barriers that may affect parts of this market. This includes the package of remedies from the Financial Advice Market Review (FAMR), which considered both supply and demand-side barriers. The FAMR recommendations update was published in April 2017 and the review of the outcomes from FAMR is expected in 2019. We have also undertaken previous reviews looking at regulatory barriers to, for example, innovation in digital and mobile²⁹, and cloud-based solutions.³⁰ As part of our Smarter Consumer Communications work we also considered the impact of regulation on good communication and the impact of innovation on communications.³¹

Liability Driven Investment

- 8.8** More respondents were confident that the market for Liability Driven Investment (LDI) services was working well, though some respondents felt strongly that it was not.

28 These principles are provided in the FCA Mission. The other three of the five principles are:

- Cooperation between regulatory authorities
- Influence over standards
- Opportunity to recruit and maintain a skilled workforce

29 www.fca.org.uk/publications/feedback-statements/fs16-2-feedback-statement-call-input-regulatory-barriers-innovation

30 www.fca.org.uk/publications/finalised-guidance/fg16-5-guidance-firms-outsourcing-%E2%80%98cloud%E2%80%99-and-other-third-party-it

31 www.fca.org.uk/publications/discussion-papers/smarter-consumer-communications-further-step-journey

- 8.9** Respondents commented on the complexity of LDI strategies and had mixed views on whether this was beneficial for clients. Investment consultant respondents said that adopting LDI led to better outcomes for schemes. However one think tank was unconvinced that these strategies provided better returns, especially given the additional risk.

LDI – our response

We found no further evidence to suggest that we should alter our findings or undertake further specific analysis on LDI.

We considered the responses raised in light of our institutional disclosure proposals in Chapter 13 and 15. We also considered the degree to which these responses relate to the wider issues that trustees face in evaluating the advice provided by investment consultants, and this is reflected in our findings in Chapter 10. We would expect that if investment consultants can better demonstrate the quality of advice they have provided, then trustees would be better able to judge whether the solutions they recommend, such as LDI, are right for them.



9 Feedback on other topics in the interim report

Scope

- 9.1** Some respondents noted that our analysis did not focus on alternative asset classes and our findings should therefore be seen in this context.
- 9.2** Several respondents were concerned that our analysis focused on larger asset managers.
- 9.3** Some respondents said our analysis should have considered the wider long-term savings market, particularly when considering the retail market.

Scope – our response

Our original scope as set out in our terms of reference did not include alternative asset classes. We therefore did not focus our analysis on these. However, we did receive some feedback on certain alternative asset classes such as private equity and hedge funds as part of our institutional analysis.

We agree that some parts of our analysis did focus on larger asset managers, in particular our profitability analysis. We were concerned that we would otherwise place a disproportionate burden on smaller firms as we requested a large amount of information. We also intended to achieve the greatest possible coverage of the whole market and focusing on the larger firms enabled us to do this. For the majority of our pricing and performance analysis, we used a broader dataset which included third party datasets and therefore includes a large proportion of products available for sale in the UK. As part of our remedy design we consider how our proposals may apply to and affect firms of different sizes and business models.

While we accept that the savings market could be relevant to retail investor decision-making, we did not include this within our scope as we were focusing on how competition works in the asset management market. We have previously assessed the effectiveness of competition in the cash savings market.³²

32 www.fca.org.uk/publications/market-studies/cash-savings-market-study

Regulatory context

- 9.4** Respondents generally wanted us to consider any remedies in the context of existing initiatives, in particular MiFID II, the extension of the SM&CR to investment firms, and PRIIPs. Respondents were keen to ensure that remedies left the UK with a regulatory regime consistent with other parts of the EEA as we approach EU withdrawal. They said that we had not examined the full effects of RDR, and generally want us to wait until we have analysed the implications of all existing regulatory change. They also stated that the costs of implementing regulatory change are ultimately borne by customers and that we needed to consider the impact of the full suite of changes in this context.

Regulatory context – our response

We recognise that there are a number of recent and forthcoming regulatory changes which will affect asset managers and the remedies we have proposed sit within this wider policy context. These include MiFID II, PRIIPs and the SM&CR. In considering the most appropriate remedies, we have thought about whether the concerns we have identified will be addressed by these regulatory changes.

Where we consider that forthcoming regulations are likely to address our concerns, we are looking at ways in which we can complement these changes. In some areas we are aware that there is likely to be further clarification at a European level, and we intend to consult on related proposals in light of this.

Competitiveness

- 9.5** Many respondents welcomed our intention to consider the impact that the proposed remedies will have on the attractiveness of the UK as a place to do business. They argued that the UK is entering a critically important political period and there is a lot of uncertainty and many challenges around EU withdrawal which we should take into account when considering the proposed remedies or any regulatory changes. Respondents urged us to avoid adding additional layers of requirements on top of existing regulations.

Competitiveness – our response

As we noted in the interim report, we have considered the impact our proposed remedies will have on the attractiveness of the UK as a place to do business and will continue to do so with the final package of remedies.

Although we recognise that the proposed package of remedies will probably increase costs for some firms, we expect that the benefits will outweigh any costs. We also expect that any improvements to outcomes for investors will lead to the UK asset management industry being a more attractive place to invest and therefore improve the relative competitiveness of the UK market.



In most cases we are required to undertake a full impact assessment and cost-benefit analysis when we introduce any regulatory or rule changes.

Non-disclosure agreements and most favoured nation clauses

- 9.6** Broadly, respondents confirmed some use of non-disclosure agreements (NDAs) and most favoured nation clauses (MFNs) in this market. They also agreed that there may be competition consequences from these kinds of agreements.
- 9.7** Respondents commented on the infrequent use of NDAs. A respondent said that the individual and specific nature of the agreements mean that if the details were disclosed they would be of limited use to other market participants. An asset manager was concerned that if confidential agreements were made publicly available third party managers could be reluctant to enter into individually negotiated agreements and this could lead to less beneficial outcomes for investors.
- 9.8** Several respondents said that MFNs can act as a barrier to fee reduction, though other respondents noted that they were used infrequently. Respondents also said that these were driven by clients, who saw them as a protection.

NDAs and MFNs – our response

Respondents appear to broadly agree with our analysis of the prevalence of and the effects of both MFNs and NDAs.

Respondents appear to be more concerned about the likely effects of MFNs in the asset management market, particularly where there are few clients or few providers for a given product or service. However, respondents did not agree on whether regulatory intervention would help or hinder investors' ability to negotiate. We have considered whether there is any need for us to intervene immediately and we do not see significant or specific evidence to suggest that this is necessary.

Vehicles and structures

- 9.9** A few respondents provided comments on closed-ended vehicles. A trade body suggested that certain closed ended-funds have had strong relative performance driven by structural factors. They argued that this is because they do not have to worry about liquidity constraints affecting fund redemptions and so have lower transaction costs, which create less of a drag on performance. These respondents said that segments of the intermediary market such as advisers have not been using closed-ended investments despite their strong performance. They felt this is a market failure and that we should consider intervening as this would improve competition.

- 9.10** Respondents suggested that any remedies should be implemented equally across investment vehicle structures to ensure the market is not distorted or give the impression the FCA favours one structure over another.

Vehicles and structures – our response

Our work did not specifically consider whether there are barriers to advisers recommending certain investment vehicles over others. In the Post-implementation review of RDR we noted that sales of investment companies had increased significantly since the RDR.³³

Investors can access retail investments through other products as well as authorised funds. Insurance companies offer retail investment products in the form of unit-linked or with-profits insurance products, such as personal pensions, investment bonds or endowments. Consumers can also invest in funds set up as closed-ended investment companies, including investment trusts. The asset management market study did not directly focus on unit-linked, with-profits business or investment companies.

However, we are aware that concerns the market study highlights around value for money and governance in authorised funds may also exist for other types of investment products. Therefore, as set out in CP17/18, we are seeking views from all relevant stakeholders on whether we should consider extending similar remedies to other types of retail investment products and, if so, whether these remedies would require specific modification to be appropriate in each circumstance.

10 The role of investment consultants

10.1 We looked at the role of investment consultants and their impact on outcomes for institutional investors.³⁴ We found that:

- The investment consultant market is relatively concentrated and switching rates appear low.
- On average, consultants are not able to identify managers that offer better returns to investors. However, the manager selection process ensures that asset managers meet minimum quality standards and reduces operational risk for investors.
- Consultants do not appear to drive significant price competition between asset managers. Consultants do not place a lot of weight on manager fees in their ratings, although in some instances they can help investors in negotiations on price.
- Investment consultants' advice on asset allocation and investment strategy is significantly more influential in terms of outcomes than the advice on manager selection. However, many institutional investors struggle to monitor and assess the performance of the advice they receive. There is no standardised framework to assess the quality of advice or to help investors assess whether they are achieving value for money.
- For some investors, fiduciary management offers a way to pool their money to achieve lower costs and get wider exposure to different managers and solutions. However, we have concerns about conflicts of interest in fiduciary management, which is increasingly offered by investment consultants and fund managers. These issues are exacerbated because investors cannot assess whether the advice they receive is in their best interests.
- Fiduciary managers' performance and fees appear to be among the most opaque parts of the asset management value chain. A lack of publically available, comparable performance information on fiduciary managers also makes it hard for investors to assess value money.

Investment consultancy market

10.2 Responses to our findings on the overall structure and competitive dynamic of the investment consultancy market primarily came from investment consultants. Other respondents included asset managers, interest groups, pension schemes and trade bodies.

10.3 A number of investment consultants said we had overstated some of the concerns raised, including concentration levels in the market and the effectiveness of the

³⁴ Investment consultancy services' is defined in paragraphs 5.2-5.4 of the terms of reference in our published provisional decision to make a market investigation reference www.fca.org.uk/publication/market-studies/ms15-2-2-a-mir.pdf

demand side. Other respondents mainly agreed with our concerns, especially about the weak demand side where they consider information asymmetry is also a factor. Some said that independent trustees are becoming more common in helping to address the knowledge gap.

- 10.4** A small number of respondents disagreed that there is a weak demand side, in particular that smaller clients are less likely to challenge than larger clients.
- 10.5** A few respondents disagreed with the concentration figures in our interim report. They provided alternative figures suggesting that the market share of the largest three investment consultants could be less than 50%.
- 10.6** A small number of respondents suggested that the scope of our work on investment consultants was too narrow and focused too heavily on the effectiveness of advice on manager selection.
- 10.7** One investment consultant challenged the switching figures we used saying these were lower than they had seen in practice. They suggested that our sample size was too small and over represented the smaller pension schemes. A number of respondents also pointed out that clients will often carry out reviews and decide not to switch. Generally there was agreement that switching is not difficult but that trustees are often reluctant to do so.

General comments on our analysis of the investment consultancy market – our response

We agree with respondents who pointed out that the market is not homogenous and clients vary by size, type and behaviour. There are also a variety of reasons why clients use investment consultants. We highlighted this in our assessment of institutional investors. However, we believe the issues we highlighted affect both a large proportion of the market and the effective functioning of competition in the whole market, even if they affect some market participants more than others.

There are a number of ways of measuring market share which lead to different outputs. The interim report used firm revenue data and on this basis, Aon Hewitt, Mercer and Willis Towers Watson combined, have at least 56% of the revenues in the advisory market.³⁵ In response to the feedback we received, we also looked at the proportion of assets held by the clients each consultant advises. On this basis, the share of the market held by the largest players increases.³⁶ On the other hand, calculating the market share by the number of clients leads to lower market share estimates for the larger consultants as the smaller consultants will often have a higher number of small clients.³⁷ Overall we think that looking across these measures still suggests the market

35 In 2015 the FCA collected revenue data on 12 of the biggest investment consultants; the largest three consultants represented 71% of revenues. This data covers around 80% of mandates based on Mandatewire data. The size of mandates for the remaining 20% of the market are likely to be smaller meaning that the share of revenues will fall within the range of 56% and 71%. Including fiduciary management revenues we would estimate the market share to be between 54%–68%.

36 The largest three consultants clients represented almost 80% of the assets held in our sample meaning that an estimate of their market share on this basis would be between 63% and 80%

37 Respondents suggested that the market share of the largest three consultants' based on number of clients was around 50% based on survey data from the PLSA, Mandatewire and Greenwich associates.



is relatively concentrated. It is unclear whether the smaller firms will continue to gain ground, as stated in their responses, or whether further movement towards fiduciary management will benefit the largest investment consultants.

In our interim report we stated that there were low levels of switching in the investment consultant market. We presented this with other findings, for example the lack of standardised and easily comparable performance data to suggest that there could be barriers to effective competition in the market.

In the interim report we provided the results from our survey of institutional investors where around 90% of respondents had not switched in the last five years. We also acknowledged the limitations of the survey data. A respondent argued that, in practice, the switching rate was higher. Based on the feedback provided, we took a further look at the information provided by a sample of investment consultants on the number of clients leaving them each year. The data suggests that at least 74% of the investors in our sample did not switch over a 5 year period.³⁸ While this confirms the switching rate is relatively low, we acknowledge that the optimal level of switching depends on the market and the level of switching costs involved. We did not carry out a comprehensive analysis of this during the market study. However, from the evidence we reviewed in the interim report and the subsequent responses, we believe that competition in the market could be improved if investors found it easier to compare providers.

Conflicts of interest in investment consultancy

10.8 Many respondents repeated the concerns in the interim report that potential conflicts of interest and misaligned incentives could affect the quality of advice provided by investment consultants. The main concern raised by respondents related to investment consultants' ability to act independently when they also offer fiduciary management services, and that they are potentially pushing existing advisory clients into using their own fiduciary services.

10.9 Respondents also raised other aspects of investment consultants' business models:

- Their remuneration model. Here a fee structure based on a retainer and fees for manager selection might encourage manager churn rather than focusing on asset allocation.
- That they might have an incentive to make their services more complex than necessary in order to justify their advice. This concern was linked to a wider issue that trustees may have limited ability to understand or challenge the advice that they get.

³⁸ This is a lower bound estimate as the data includes clients who switch multiple times and others who may have left the market. They also focus on the larger investment consultants but may indicate that a higher proportion of investors switched investment consultants between 2011 and 2015 than was suggested by our online survey.

- Where they offer training seminars these often appear to be focused on selling more services rather than educating trustees in a neutral way.

- 10.10** Investment consultants said that their long-term relationship with clients is much more important than the short-term financial incentives that may be created by churning portfolios.
- 10.11** Investment consultants also noted that the prevalence of complex strategies is due to the wider economic environment and is consistent with acting in the best interests of investors, and is not due to misaligned incentives. Other respondents reported that they had experienced investment consultants recommending overly complex solutions, which they then found created further opportunities for their provider to offer them more services.
- 10.12** Investment consultants said that the fiduciary management offering can span a range of services, from pure aggregation to a fully discretionary and delegated service. They determined the specific type of fiduciary management service provided in full consultation with the client. An investment consultant said that a separate contract must be signed to enter a fiduciary arrangement, and that this measure would prevent clients from 'slipping' into this service. Another investment consultant suggested that the number of their existing clients moving to other providers for fiduciary management was evidence that this conflict is not having an effect.
- 10.13** A respondent argued that vertical integration between advisory and fiduciary services is the most serious potential conflict of interest. This is because the investment consultant plays a central role in the institutional asset management market and their advice is likely to be important in determining outcomes. This respondent argued that vertical integration could therefore stop asset managers competing on a level playing field.
- 10.14** We also raised a concern that gifts and hospitality from asset managers could create conflicts of interest for investment consultants that provide asset manager ratings and recommendations services to clients. Respondents raised a similar concern about this where the investment consultant is providing these services while at the same time providing consultancy services to asset management firms. Specifically, they were concerned that any revenues investment consultants earned from asset managers could create conflicts of interest. Some investment consultants reiterated that they have processes in place to ensure asset managers' gifts, hospitality or revenue from providing services did not affect their advice. Others suggested that the level of gifts and hospitality they received was insignificant and declining. However, they also recognised that across the market policies to prevent conflicts could be enhanced. Some noted that they had tightened their existing policies since our interim report.
- 10.15** Some respondents also called for more clarity on what gifts and hospitality can and cannot be accepted or provided. However, some respondents also thought MIFID II would likely lead to a further fall in the level of gifts and hospitality. A small number of asset managers were concerned that the regulatory focus on gifts and hospitality would damage the ability to build trusting working relationships which they believe is beneficial to clients. A trade body differentiated between hospitality which is beneficial and hospitality which is not helpful to business discussions.



- 10.16** Consultants highlighted that they have policies in place to prevent any revenues received from asset management groups from impacting their ratings process. An investment consultant demonstrated the independence of their ratings by providing statistics showing that they had provided a higher number of negative ratings to asset managers who had purchased services from them than positive ratings.

Conflicts of interest in investment consultancy – our response

Although there are inherent conflicts of interest in the investment consulting business model, these must be properly managed to prevent distortions in competition that disadvantage investors. Our interim findings suggested that there were differences between firms in how they were managing these conflicts. We are encouraged that a number of investment consultants' responses suggested they are improving their policies to manage conflicts of interests. However, we are still concerned about how effectively conflicts are being managed, particularly conflicts that arise from offering both advice and fiduciary management. In the interim report we proposed a market investigation reference to the CMA to look at this issue in more depth, along with other concerns we identified in investment consulting services. We received UIL of the reference and are currently publically consulting on our provisional view to reject the UIL before making a final decision on the market investigation reference. For further information please refer to Chapter 15.

Since the interim report we have further examined whether there was a link between asset managers providing gifts and/or hospitality to investment consultants, or investment consultants selling services to asset managers, and the likelihood of the asset managers' products being highly rated. This further analysis took into account additional factors that could also explain positive ratings, such as the asset class and an investment strategy's past performance. For some consultants in our sample we have found a significant positive association between receiving gifts and/or hospitality and the likelihood of providing a high rating, as well as significant positive association between revenues received from asset managers and the likelihood of providing a high rating. However, at this stage we have not been able to satisfy ourselves that our data set is sufficiently reliable, or that there are no other factors which could explain the statistical association. Therefore, we cannot conclude that ratings were influenced by gifts and/or hospitality or revenues received.

Fee focus

- 10.17** We received only a small number of responses on this topic. All of these responses were from investment consultants and all argued that they place more focus on the negotiation of fees than we suggested in the interim report. We found that investment consultants did not appear to drive asset managers to complete on fees.

10.18 Investment consultants have told us that:

- They conduct fee surveys which help them to assess whether the fee level is right for the mandate.
- They consider fees when they give a rating (which strengthens their negotiating position).
- They are able to negotiate fee discounts for clients both through bespoke individualised negotiations and through pooling smaller clients' assets together.
- The fiduciary management offering enables them to negotiate fees down on behalf of clients.
- As we noted, they remove outliers during the ratings process, but the fee levels and willingness to negotiate form part of the rating. They argue that this reflects the full value of the service (net of fees).

10.19 An investment consultant told us that they calculate the manager's share of 'value add' and where asset classes do not meet their targets they would avoid them.³⁹**10.20** Consultants also told us about the stages at which fees are negotiated. A few consultants focus on fees when reviewing/rating asset managers. Most consultants negotiated fees at the point clients selected an asset manager. Fees are always negotiated for fiduciary management.**Fee focus – our response**

In the interim report, we identified that fees were considered as part of the ratings, although this was typically not given significant weight. This was based on the responses firms gave us. We provisionally concluded that the fee focus in the ratings was usually on removing outliers, rather than driving down costs. Respondents have subsequently told us that negotiation on fees is also part of their rating process. So it is clear that there are differences between investment consultants in the way they focus on fees in the rating process.

For fee negotiations, we understand that some firms do negotiate fees for clients. In particular, firms have told us that they negotiate fees down for their fiduciary management offering. Notwithstanding these differences between investment consultants, we believe that more focus could be placed on fees. In particular we note that in our analysis of segregated mandate pricing, on average the asset-weighted annual management charge has been relatively stable from 2006-2015 (see Annex 3). Although this will cover mandates which were and were not advised by investment consultants, it appears there has not been significant fee pressure for institutional investments.

³⁹ This investment consultant defined this as the manager's fee taken as a percentage of the strategy's targeting (ex-ante) performance in excess of the relevant benchmark.

Fiduciary management

- 10.21** We received many responses to the interim report that pointed to issues with the selection process of fiduciary managers. They focused on a perceived conflict by investment consultants when moving clients from an advisory relationship to a fiduciary management arrangement, low tendering levels, and the lack of available comparative information when selecting which consultant to use.
- 10.22** Respondents disagreed with our interpretation of some elements of our evidence in the interim report. They also felt that some evidence we relied on was inaccurate. A number of respondents had concerns that the research we referenced understated the current level of competitive tendering of fiduciary management appointments.⁴⁰ An investment consultant also pointed out that we had misinterpreted a survey regarding the use of existing advisors.⁴¹ Another respondent noted that tendering processes are more detailed and comprehensive than we had suggested.
- 10.23** Some investment consultants disagreed with what they perceived to be a suggestion that they push advisory clients into purchasing fiduciary management services and said this was typically a decision led by the client. However, many respondents were concerned that trustees may not fully understand fiduciary services and could benefit from improved guidance on this. For more information on this feedback, please see Chapter 15.
- 10.24** Several respondents also said that fiduciary management should not be seen as a distinct service, but rather an improved version of investment consultancy with the level of service depending on client needs. A trade body suggested our definition of fiduciary management was too narrow, and that delegating responsibility for all investment decisions is just one variety of fiduciary management. This respondent stated that manager-of-manager and fund-of-fund⁴² products are also part of a fiduciary management service.
- 10.25** Some respondents said that the interim report did not fully recognise the benefits to clients from using fiduciary management. These included allowing pension fund trustees to focus more on strategic decisions, and increasing negotiating power through asset pooling. A few respondents stated we focused too heavily on costs and that, while costs charged for fiduciary management would typically be higher than for advisory services, the overall costs paid by trustees are often lower. We received a number of suggestions on methods for improving the presentation of fiduciary management fees, charges and performance. A few respondents suggested that there was an increasing availability of fiduciary management providers and a number of potential market entrants. They thought that this was generating competitive pressure in the market.

Fiduciary management – our response

Our interim report highlighted that fiduciary management does bring some advantages and can work well for some clients but that there are also some issues which require addressing. We have not received any

40 KPMG Fiduciary Management Market Survey (2015).

41 Aon Hewitt Fiduciary Management Survey (2015).

42 In these funds, the asset manager will select underlying funds or managers (either in-house or third party) and allocate money to be managed by them.

evidence which has changed our view that the competitive process in the market for fiduciary management could be improved.

For evidence on tendering levels for fiduciary management appointments, we have subsequently looked at a more recent third party survey. This finds the level of tendering when choosing a fiduciary manager is still low.⁴³ While 63% of investors received third party advice, only 13% ran a selection process when the investment consultant proposed fiduciary management. This survey also suggests that 41% of respondents had not considered more than one fiduciary manager.

We accept the point made about the survey data we used to illustrate tendering levels in fiduciary management. The statistic used in the interim report to show the proportion of clients appointing existing advisors should have read that: '58% of respondents would appoint the fiduciary business of their existing investment consultant or actuarial adviser as their provider'.

We agree that the range of services provided by fiduciary managers is broad and includes fund of fund and manager of manager in-house products. We consider that many of our concerns about fiduciary management apply equally to other in-house products. This includes the conflicts of interest concerns about performance reporting.

Investment consultant performance

- 10.26** The majority of responses on our analysis of investment consultant recommendations were from investment consultants. The bigger investment consultants strongly disagreed with our finding that on average investment consultants are not able to identify managers that outperform, although a couple of smaller investment consultants agreed that consultants are not able to identify asset managers that offer better returns to investors. Instead, these consultants see the ratings and recommendation process as a form of quality control.
- 10.27** Currently, institutional investors face a set of thousands of investment products, which can make it difficult to select the most appropriate. Given this range of products, investment consultants' due diligence can help narrow choices for clients, and some investors told us they valued having a long or short list from which to choose managers. We also received feedback that consultants could have artificially created demand for an unnecessarily wide range of products, which reinforces demand for their ratings and recommendations services.
- 10.28** A respondent disagreed that there is added value from the due diligence that consultants provide. They suggested that the reason search costs were so high was because consultants offered pension funds a choice of thousands of funds, and that this spurious choice destroys value for clients in the long term.

43 LCP fiduciary management survey 2016.



10.29 Investment consultants generally pointed to the fact that the interim report only assessed performance against a benchmark. They did not believe this adequately captured the benefits of their recommendations. In particular, they said that their recommendations also reflect risk management considerations. These respondents noted that risk is not just at fund level but also at scheme level, and the investment products they recommend to clients would, for example, often aim to reduce funding level volatility. Respondents also argued that the effects of asset allocation decisions are difficult to assess against benchmarks.

10.30 We received detailed feedback from several respondents about the interim report's analysis of the predictive value of investment consultants' ratings. Their key points were that our preliminary results relied on the eVestment databases' accuracy. Several respondents felt that the database required adjustments to improve its accuracy and correct for alleged biases. Specifically, respondents believed that the eVestment database was subject to potential:

- backfill bias
- bias related to the inclusion of simulated returns
- potential survivorship bias
- headline rather than actual fee data reporting issue

Investment consultant performance – our response

We consider that returns that have been backfilled or simulated by asset managers have the potential to be biased upwards. So, we have made adjustments to the eVestment database to remove (i) time periods that were backfilled by asset managers, and (ii) time periods in which returns were simulated by asset managers.

The effect of these two adjustments is to substantially reduce the outperformance of both highly rated and non-highly rated products. The preliminary results in the interim report showed quarterly non-highly rated gross outperformance of 23 bps and highly rated quarterly gross outperformance of 20 bps

The updated results show quarterly non-highly rated gross outperformance of 0.08 percentage points and highly rated quarterly gross outperformance of 0.10 percentage points. We find that outperformance of non-highly rated and highly rated products are not significantly different from each other. However, neither highly rated nor non-highly rated products generated outperformance that was significantly different from zero. The same result holds net of fees. Therefore, we find that as with our preliminary analysis, consultants' highly rated products aggregated together did not outperform non-highly rated products. Further information can be found in Annex 5.

We continue to agree that investment consultants' due diligence and short lists can be valuable to investors. However, we found investment consultants' recommendations drive fund flows, so their

ratings are likely to impact the way competition works for institutional investment products. Where these ratings do not deliver better outcomes for investors compared to non-highly rated products, the potential pool of asset managers which investors are likely to choose from could be widened. This may improve the relative negotiating power of investors. It is therefore important that clients are clear what the ratings represent, and are able to assess whether the investment consultant is effective at identifying managers that can outperform the benchmark, where that is what the rating aims to achieve.

Performance monitoring

- 10.31** A few investment consultants gave us details of how they currently monitor both qualitative and quantitative elements of their services in order to present this information to their clients.
- 10.32** The majority of respondents supported the need for improvements in information on investment advice given to clients, and agreed that asset allocation was an important element. There was a general consensus across investment consultants that creating reporting for the monitoring of investment advice is challenging for reasons such as each client having different investment objectives and that clients may or may not follow the advice they are given. However several respondents suggested improvements to reporting on the impact of advice. A few respondents considered that a template-style disclosure would not prove beneficial as it assumes too great a level of standardisation. A respondent also pointed out that investment consulting advice is only one factor in trustees' decisions, so it is difficult to judge the performance of advice by using only scheme outcomes.
- 10.33** A small number of investment consultants believed that our analysis had taken too narrow a view of the benefits of investment consultants, and argued that the benefits are not limited to fund performance alone.
- 10.34** Some respondents believe the value of advice should be measured against client- or scheme-specific objectives and not against an 'arbitrary benchmark'. A few firms have developed their own benchmarks and feel they can demonstrate the value of their advice. However, some cautioned against greater use of benchmarks across the market for public peer-group analysis as they felt this can focus attention on the wrong metrics and lead to poor or inaccurate comparisons. A firm also said that performance monitoring should be structured to include monitoring of the scheme's liabilities, supported by a balanced scorecard of metrics to give a fuller picture of the value being delivered to trustees.

Performance monitoring – our response

We recognise that performance monitoring is one of a range of factors that trustees may use to select investment consultants. We still believe that trustees would benefit from better information to allow them to compare investment consultants, and decide whether their asset allocation advice is delivering good outcomes.



We agree that it may be complex to provide this information and that benchmarking could create unintended consequences. However, we believe there is value in further exploring if there is a suitable solution.

In our provisional market investigation reference, we raised concerns around the weak demand side in the investment advisory sector and about investors' ability to assess the quality of investment advice. In response, the three largest investment consultants submitted UIL designed to address these concerns. We reached a provisional view on these proposals and are publically consulting to seek views on them before making our final decision. For further information please refer to Chapter 15.

Part B: Our current thinking on a package of remedies

Feedback on our remedy proposals

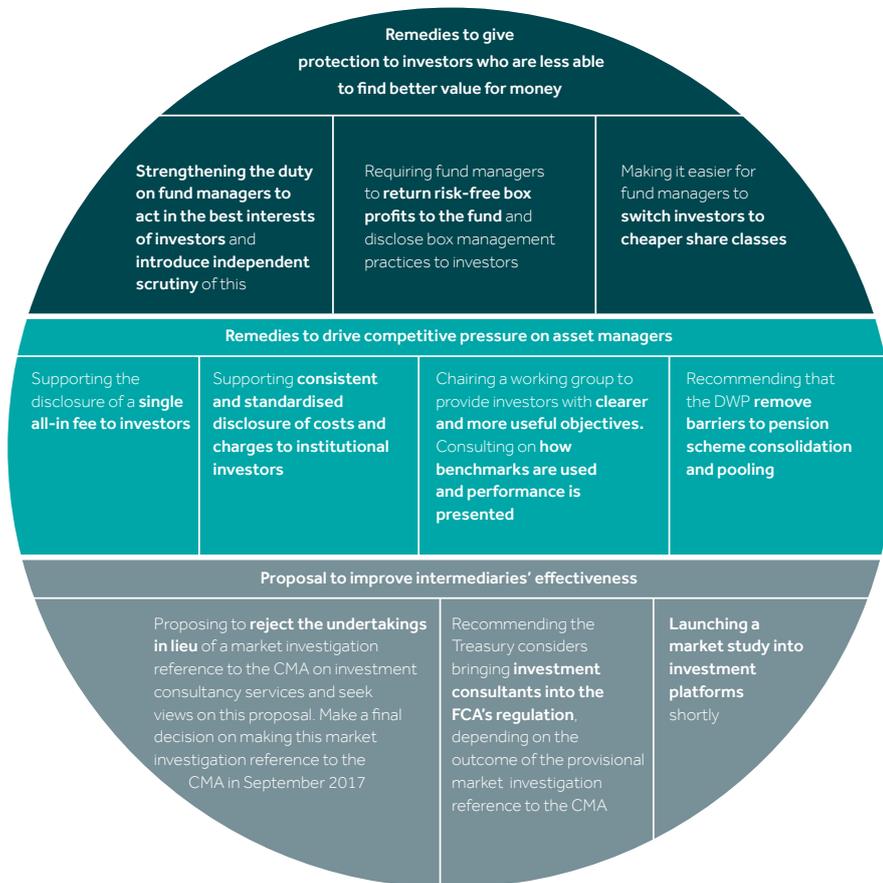
Respondents broadly agreed with the overall aims of the remedy package proposed in the interim report. However, we set out a number of different options within this package and respondents gave detailed feedback on the following areas:

- Governance
- Objectives, benchmarks and performance
- Transparency of fees and charges
- Other remedies relating to retail investors and retail intermediaries
- Other remedies relating to institutional investors and investment consultants

We have taken the feedback from respondents into account and, whilst the overall objectives that the remedies seek to achieve have remained the same, the comments received have shaped the way in which we seek to achieve these.

In the interim report, we set out our proposals for remedies. In Part B of this report we give an overview of the feedback we have received against each of the main remedy proposals. Part B also outlines our final remedy proposals and what we intend to do next.

This section includes chapters covering our package of remedies.



For more information about the feedback we have received against each of the main topics we analysed please refer to Part A of this report.

11 Governance

In this section we give a summary of the responses.

We are consulting on proposals to:

- clarify expectations around value for money
- ensure transparency of actions that governance bodies take to satisfy their consideration of value for money
- introduce independence in governance structures

We provide our final recommendations on governance remedies for AFMs in the accompanying CP17/18. We also consider the degree to which these rules should apply to other similar investment products.

We are also setting out our intention to introduce a new Prescribed Responsibility under the SM&CR⁴⁴ to act in the best interests of investors including a consideration of value for money.⁴⁵

A strengthened duty on asset managers to act in the best interests of investors

Governance

11.1 Existing FCA rules require AFMs to act in the best interests of their investors and to prevent undue costs being charged to the scheme or unitholders. These obligations should be overseen by the board of the AFM – the senior committee made up of the Directors of the AFM. It is their role to set the overall direction of the firm, and to do so in a way that complies with our rules and considers the best interests of the investors in the funds.

11.2 As set out in the interim report, we found that:

- Fund governance bodies, whether in-house or outsourced, tend to lack independence from the fund manager and do not appear to exert effective challenge on value for money
- The AFMs of authorised funds do not generally robustly consider value for money for fund investors
- In particular, AFMs often do not compare the asset manager's fees for managing a retail fund's portfolio with the fees the asset manager charges comparable institutional client accounts. This means they cannot assess if the difference in fees is reasonable, compared to the differences in costs.

⁴⁴ A set list of responsibilities under our and the PRA's rules that must be allocated to firms' Senior Managers with the intention to ensure that every part of a firm's business or activities has a Senior Manager with overall responsibility for it. The SM&CR is an accountability framework.

⁴⁵ We will formally consult on the introduction of the new prescribed responsibility as part of the wider consultation on the role out of the SM&CR regime later this year.



- 11.3** These issues are also likely to contribute to a number of our overall findings.
- 11.4** We found that asset management products and services are complicated, objectives may not be clear, fees may not be transparent and investors often do not appear to prioritise value for money effectively. They therefore need strong governance to act on their behalf. This does not appear to be happening currently. This potentially contributes to the limited price competition for actively managed funds, asset managers being less effective at controlling more complex costs and some funds not clearly communicating their investment strategy to investors. This can also result in investors choosing funds that are less likely to meet their expectations.
- 11.5** We therefore set out a number of proposals to strengthen the duty for asset managers to act in the best interests of investors. In particular, we set out the following options:
- a.** Keep existing governance structures but clarify their duties: the AFM Board could be expected to demonstrate how it has complied with the strengthened duty to act in investors' best interests.
 - b.** Strengthen the requirements on senior managers of the AFM: strengthening the duties of the AFM board members by extending the SM&CR to some AFM board members, which would apply to all firms authorised under FSMA from 2018. We could seek to require that senior managers consider value for money as part of this new regime's introduction.
 - c.** Change the composition of existing governance bodies to create more independence: the existing AFM board structure could be reformed to mandate it to have a majority of independent members and an independent chair.
 - d.** Create an additional governance body: a separate independent body could be introduced. This would be modelled on the Independent Governance Committees (IGCs) for DC pension funds and would carry out the new duties, leaving the existing AFM board with its current responsibilities. We could enforce the new body's obligations by extending the SM&CR to its members.
 - e.** Replace existing governance structures with a new body: replace AFM Boards with majority independent fund boards, similar to the US mutual fund structure, with their responsibilities underpinned by the SM&CR.
 - f.** Greater duties on trustees and depositaries: an alternative approach would be to leave current AFM governance structures unchanged and impose greater duties on trustees and depositaries to assess whether the fund manager is delivering value for money.
- 11.6** Many respondents supported proposals to improve fund governance, with a large number supporting the FCA being clearer on our expectations around value for money.
- 11.7** Only a small number of respondents felt that no change was necessary. These respondents expressed the view that existing requirements and responsibilities on governance bodies were sufficient to address our concerns. Some also pointed to the forthcoming regulatory changes including, for example, MiFID II product governance

and the SM&CR.⁴⁶ Other respondents were concerned about the additional complexity and cost of potential new governance structures.

- 11.8** When thinking about defining value for money, a number of asset managers argued that this should not focus solely on costs. They felt it should include wider measures of value, such as performance, risk, service and other factors. Many stakeholders recognised that value for money is not straightforward to define, but would welcome a clear definition of what we mean by value for money and more clarity on our expectations. Several respondents noted that any definition would need to be broad to reflect potential dissimilar investor expectations such as different time horizons and risk appetites. A respondent noted that some work has already been done to define value for money in the workplace pension scheme context. Some argued that we should also consider including a value for money requirement for distributors.
- 11.9** Many felt that FCA guidance alone would be less likely to address the concerns. However, there was not a clear position on which of the proposed changes in the interim report would be most likely to deliver better outcomes. Although some respondents shared views on the likely effectiveness of the different options in light of different profile of certain investor types and their relative negotiating power, such as retail investors or smaller pension schemes.
- 11.10** Some asset managers and other stakeholders supported using the SM&CR to reinforce governance changes. Some also suggested that we wait to see the impact of SM&CR before we consider any further changes.
- 11.11** There was also support for some level of independence. Some respondents noted that they already use independent representatives in their governance structures. There were mixed views on the number of independent representatives, the roles or levels at which independence would be required, the mechanisms for introducing it and whether it would be effective. The majority of asset managers who supported independence were in favour of minority independent representation. A small number of respondents raised concerns about a potential shortage of suitably qualified independent people, and others noted that it would be important for us to define what 'independent' meant in this context.
- 11.12** Other respondents focussed on the skills and expertise of representatives in governance structures, as well as their opinion that governance can be strengthened by increasing the diversity of thought and experiences represented.
- 11.13** However, there was little support for a wholly new governance body (such as in the US) or an IGC style model. Most felt that the costs for these new models would outweigh any benefits, and noted that investors are likely to bear these costs. Some respondents explained the differences they saw between existing UK and US models which meant it would be inappropriate to adopt US rules in the UK. Some thought that the IGC style model has not yet been proven to be effective.
- 11.14** Most respondents did not favour trustees and depositaries taking on a role in assessing value for money. They suggested that they do not have the capability to do this at present and that this would not address concerns around conflicts of interest.

⁴⁶ We, along with the PRA, introduced a range of policy changes that aim to increase individual accountability within the banking sector. The rules make it easier for firms and regulators to be clear about who is responsible for what. The Bank of England and Financial Services Act 2016 includes the extension of the SM&CR to all FSMA authorised firms. We are developing our approach to the extension of the SM&CR and our current plan is to consult during the Summer of 2017.



- 11.15** Respondents also raised issues about the scope of governance requirements and how these would work with existing different governance structures. Respondents also asked us to consider potential unintended consequences and take a proportionate approach in any governance remedies.

Governance – our response

We are proposing to strengthen the requirements for asset managers to act in the best interests of investors. This is through a combination of clarity of our expectations, introducing independence on governance boards and introducing a prescribed responsibility under the SM&CR. For information on our proposals on governance please see the accompanying CP17/18.

Other suggestions to encourage asset managers to show they provide value for money

- 11.16** We asked respondents if there were any alternative supply side remedies that would encourage asset managers to demonstrate that they are providing value for money.
- 11.17** Several respondents said that competitive pressure either already does, or could, result in asset managers working harder to demonstrate that they are providing value for money. They noted intermediaries were vital to providing targeted demand-side pressure on value for money.
- 11.18** Several respondents made suggestions that there should be greater transparency of decision-making processes, procedures and discussions or disclosure of investment outcomes could be directly linked to the decisions made. The format and mechanism of these suggestions varied and included yearly reviews and disclosures in annual reports as well as templates. A few respondents also referred to strengthening internal management frameworks.
- 11.19** A few respondents said firms' culture is key to decision-making and therefore an important factor in asset managers being able to generate, as well as explain, value for money for their investors.
- 11.20** Some respondents felt that comparison of value for money, including peer benchmarking of fees and improving clarity and comparability of objectives would enable asset managers to better demonstrate value for money.
- 11.21** A number of respondents suggested distribution ranking or a certification mark verifying product and service quality to rate good value for money or requiring a kind of annual fund 'health' check on value for money.

Other suggestions to encourage asset managers to show they provide value for money – our response

We agree that there is a role for intermediaries in holding asset managers to account on value for money. However, for these to be effective, we consider that competition for these service providers needs to work well and in the interests of investors, conflicts need to be managed appropriately and information about investments need to be clear and accessible. We are therefore proposing further work in the retail distribution market and more information can be found in Chapter 14. We agree that there may be benefits for intermediaries to be able to provide information to investors on value for money.

For more information on our proposals on governance please see the accompanying CP17/18.

Fiduciary duty

11.22 In the interim report we said that we preferred a regulatory solution to strengthen the duty on asset managers to act in the best interests of investors. However, we asked respondents whether there are advantages to our recommending the Government introduce a fiduciary duty by statute, which could not be achieved through regulatory reforms.

11.23 A small number of respondents, particularly consumer representatives and some asset managers, support the introduction of a fiduciary duty. This is typically described by respondents as a requirement to 'act in the best interests of investors'. Many of these respondents support this alongside the regulatory governance proposal. Some respondents had a preference for some kind of duty as they perceived that this would be less likely to involve complex rules and would be more likely to have an effect on firms' culture. Some respondents referred to the success of fiduciary duties in other jurisdictions.

11.24 Many asset managers and trade bodies do not support the introduction of a fiduciary duty. Reasons they gave include:

- Little perceived evidence of benefit. This view is supported by referring to the Law Commission's report which did not support the introduction of a fiduciary duty.⁴⁷
- That existing rules are sufficient and achieve the same outcome. However, many respondents support further clarity on our expectations in this area.
- That this would lead to increased costs and legal uncertainty and would take longer than a regulatory approach.

Fiduciary duty – our response

We still think that the most effective way to strengthen the requirements for governance bodies to act in the best interest of investors is through regulatory reform rather than a statutory fiduciary duty or duty of care.

47 www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/



As part of our broader exercise on Our Mission we have considered the issue of a Duty of Care.⁴⁸ We already have 'client's best interest' rules which have a similar effect to that of a fiduciary duty for some regulated activities, including designated investment business, UCITS and some AIF business. We also note the following:

- the FCA has a consumer protection objective of securing an appropriate degree of protection for consumers
- we can and do use Principle 6 (treating customers fairly) as a supervisory and enforcement tool to secure appropriate consumer protection
- a number of our rules oblige firms to take reasonable care for certain activities
- FSMA provides for a private individual who has suffered loss to sue an authorised firm for breaching certain rules (but not Principles)
- consumers can use the Financial Ombudsman Service to get redress which is less costly and complex than court proceedings

We note that the SM&CR was explicitly intended to improve the culture of authorised firms. We are planning to consult on introducing a new Prescribed Responsibility (under the SM&CR) to act in the best interests of investors including consideration of value for money.

We also consider that some of the cited benefits of a fiduciary duty can be achieved through regulatory reform such as the requirement for governance bodies to act in the best interests of investors.

We agree with respondents that a statutory duty would take longer to come into effect and would not provide the necessary clarity around our expectations.

12 Objectives, benchmarks and performance

In this section, we give a summary of the responses and our proposed approach on objectives, performance and benchmarks.

We have considered how some of our concerns in this area may be addressed by forthcoming regulation. We propose to undertake further work on options to improve the usefulness of objectives for investors. We intend to chair a working group on this issue, and will make sure that the consumer perspective is represented alongside that of the industry. This work could result in new rules or guidance on how objectives should be written.

We also intend to consult on new rules, so that:

- Where an AFM has chosen a specific benchmark, comparator or numerical target for a fund it should make the reasons for this clear to investors.
- If an AFM chooses not to use a specific benchmark, comparator or numerical target for a fund it should make the reasons for this clear to investors and it would be prevented from using any other benchmarks or comparators in marketing material for that fund.
- If AFMs choose to present their past performance, they must do so against the most ambitious returns target they hold out to investors (if any).

Helping retail investors identify which fund is right for them

12.1 As explained in our interim report it is difficult for even engaged investors to know what to expect from their fund. It is also difficult for them to assess whether or not their fund is performing against relevant objectives, including those set by the fund manager.

12.2 We asked:

- Would it be proportionate and effective to require fund managers to be more specific with investors by clarifying objectives?
- Are there other metrics/indications/pieces of information that could give investors better insight into likely future returns?

Clarity of objectives and the use of benchmarks and comparators

12.3 We asked respondents whether it would be proportionate and effective to require fund managers to be more specific with investors by clarifying an upfront objective and tracking performance against it over an appropriate time period.

12.4 In our interim report we considered whether we should clarify and strengthen the appropriate use of benchmarks, including their use in objectives. This included potentially requiring a benchmark or comparator to be set for all funds, against which



performance could be tracked over time. We asked whether we should set out our expectations on using benchmarks, particularly where benchmarks are used to trigger performance fees.

- 12.5** Asset management respondents' views varied. Some felt that current objectives were fit for purpose, while others suggested that there is a need to improve the clarity of some objectives. Most of those supporting additional work in this area felt that a greater focus on investors' understanding of objectives was more important than greater technical accuracy. They felt that more detail would help investors scrutinise performance against the objective.
- 12.6** Many noted the existing rules and guidance for objective setting in both UK and EU law, and that any further work in this area would need to be consistent with these. For example, asset managers referred to our existing fund supervision processes and requirements, existing COLL rules and existing UCITS requirements on selecting and using objectives.⁴⁹ Respondents also referred to our previous thematic work on objectives, such as Meeting Investors' Expectations.⁵⁰ Some respondents also said these existing requirements were a constraint on making objectives more comprehensible and accessible. They pointed out that they were generally technical disclosures and were not designed with a customer focus. Some managers thought this therefore placed a greater responsibility on intermediaries to ensure that investors understood objectives.
- 12.7** Respondents were keen to emphasise that the 'looseness' of objectives gave managers the flexibility they needed when trying to achieve the greatest return for investors. They said that tightening these objectives much further could reduce the managers' ability to achieve the best return for their investors.
- 12.8** Many respondents felt that there are situations where it is not appropriate, and may actually be misleading, to assign a benchmark to a fund. Specific examples included multi-asset funds and some illiquid asset classes. Several respondents suggested that it is difficult to select appropriate benchmarks for absolute return funds.
- 12.9** Generally, there was quite a lot of support for the existing framework (FCA authorisation, guidance on usage, previous Meeting Investors' Expectations work) being fit for purpose and not needing any further tweaking.
- 12.10** However, respondents felt that further FCA guidance on the use of benchmarks would be helpful, such as requirements about:
- whether a benchmark is being used for comparison or management
 - when and how benchmark information should be disclosed to investors
 - describing the degree to which a fund's strategy is linked to a benchmark
- 12.11** Some respondents raised concerns about the cost and lack of choice from benchmark (index) providers.

49 Collective Investment Schemes sourcebook – part of the FCA handbook.

50 www.fca.org.uk/publications/thematic-reviews/tr16-3-meeting-investors%E2%80%99-expectations

- 12.12** Some felt that investors may not understand both index and non-index sector or category benchmarks, or that they may potentially misrepresent performance, and more should be done to clarify their use. This included being clearer about the purpose which the benchmark is being used, for example, for comparison or management.
- 12.13** Several respondents felt that investors will probably always find measuring against their own personal goals and targets more useful than comparison against a fund objective. Therefore, they considered that any kind of fund objective, no matter how well articulated, will be of varying use to different investors. Several respondents suggested that time horizons over which an objective was expected to be met would be an important feature.

Clarity of objectives and the use of benchmarks and comparators – our response

We continue to believe that investors could benefit from greater clarity as well as being better able to compare objectives between similar funds. We welcome suggestions from industry about improving investor understanding of current objective wording. We will look at whether we can improve the language used and clarity of objectives to make them more useful for investors at the point of sale and on an ongoing basis.

We propose to carry out further work on options to improve the usefulness of objectives for investors and we intend to chair a working group on this issue. This work could result in new rules or guidance. In the meantime we encourage industry participants to consider the language and naming conventions they use and how investors may interpret them to avoid misleading them. For example, the IA (then the Investment Management Association) changed their sector's name to the 'Targeted Absolute Return fund sector' in order 'to emphasise that there is no explicit or implicit guarantee associated with this sector'.⁵¹ We also expect firms to continue their work to ensure that all client communications and fund documentations are fair, clear and not misleading.

We agree that the objective setting process needs to stay flexible. We agree that requirements for clear objectives should not place undue constraints on managers and so potentially negatively affect returns.

As we described in our interim report we agree with respondents that more explicit objectives might give the impression of some kind of 'guarantee' of future returns.

Many respondents noted that other existing or future disclosure rules including, for example, the PRIIPs KID, are already enough to ensure that investors are informed. We agree with respondents that it would be helpful if funds set out a suggested investment timeframe for all funds and the introduction of the PRIIPs KID will deliver a recommended holding period.⁵² The working group may consider alternative methods by which

51 www.theinvestmentassociation.org/assets/files/press/2013/20130227-01.pdf

52 Changes have been made to the FCA Handbook as a result of this Regulation, which will apply from 1 January 2018. Although UCITS schemes are PRIIPs, the requirements in the PRIIPs Regulation will not apply to such schemes until 31 December 2019, due to an exemption provided by the PRIIPs Regulation Article 32.



this information is communicated in light of mixed evidence on investor engagement with similar types of documents.

We do not currently think that all funds should have a benchmark, comparator or numerical target return. Where an AFM chooses not to set or indicate a benchmark, comparator or numerical target for a fund, we currently intend to consult on an approach that requires the AFM to explain their reasons for this to investors. We are also considering consulting on an approach that prevents AFMs who have chosen a benchmark, comparator or numerical target return using any other comparator in marketing materials.⁵³

We recognise respondents' view that investors may not understand benchmarks well in the form of both indices and sector or category comparisons. Respondents also felt that benchmarks could potentially misrepresent performance. We agree with respondents that investor understanding is likely to be low in this area. In our view this makes it all the more important to ensure that performance is reported appropriately.

We will continue to consider appropriate supervisory action in order that funds are managed in accordance with applicable rules and investor expectations. Where we see breaches of our rules we will continue to investigate them and, if necessary, take enforcement action. We also continue to review funds, including absolute return funds, at fund authorisation stage so they comply with relevant rules.

We are also proposing further work on performance fees. For more information please refer to Chapter 13.

Improving the usefulness and comparability of performance information used by investors

12.14 At interim report stage we found that it is difficult, even for more engaged and institutional investors, to assess whether or not a fund is performing against relevant objectives, including those set by the asset manager. Therefore, as well as proposals to take forward work on clarity of objectives, we also considered:

- how fund managers and other market players should communicate to allow investors to judge success over an appropriate time period
- in what circumstances it would be appropriate to provide comparators, for example, performance of passive funds in the relevant market
- whether we should require managers to explain the performance of funds that have merged/closed

53 In addition, under the new rules we intend to consult on, where an AFM has chosen a specific benchmark, comparator or numerical target for a fund it would have to make the reasons for this clear to investors, and use it consistently across regulatory and marketing materials.

- whether managers should be required to take action when funds are persistently underperforming and, if so, what form should this action take
- whether there is a role for the regulator in 'shining a light' on poorly performing funds and, if so, what form this could take

Performance disclosure and communication

- 12.15** Many respondents felt that existing or upcoming requirements are already sufficient. Examples provided included UCITS requirements such as the KIID, listing requirements for investment companies and the forthcoming PRIIPs requirements. These respondents often felt that investors could do with greater education from their intermediary rather than more disclosure.
- 12.16** Several respondents noted that a lot of information is already available to investors, and that the press or league tables can use this to make third party comparisons.
- 12.17** However, there was widespread support for clarity and transparency in communicating performance and, where relevant, benchmarks and objectives. Respondents preferred simple documentation, with some discussion of disclosure that is diagrammatic, shorter or otherwise easier to understand. Some respondents felt that a plain language text explanation should supplement other disclosures.
- 12.18** A trade body felt that it was 'reasonable' that there should be more precise reporting of returns against appropriate timelines. They felt that investors should be able to compare actual performance with target performance.
- 12.19** Respondents provided suggestions for greater client-focus in performance reporting where possible, for example, tailoring disclosure of performance to client-relevant targets.
- 12.20** Several respondents made distinctions between the timeframes over which performance is reported, the disclosure of a time horizon or holding period and the frequency of reporting. Preferences for different options varied according to appropriateness for each strategy. The main message was that changes should not reinforce tendencies to chase performance and instead should support decision-making in line with individual investors' personal targets.
- 12.21** Templates and league tables were discussed in relation to institutional investors, particularly their potential usefulness for trustees.
- 12.22** A few respondents suggested that additional factors should be routinely reported by asset managers to aid investors' understanding of long-term performance. Suggestions included active share, tracking error, total historical performance – which would reduce the effects of survivorship bias on performance reporting – and environmental, social and governance (ESG) indicators.
- 12.23** Some respondents were very strongly against using passives as comparators for active funds. Others felt that this was only appropriate where there was a passive fund that aimed to achieve the same objectives or was highly comparable. A very small number of respondents supported the idea of mandating a comparison with passive funds.



- 12.24** Respondents also discussed the use of past performance in disclosure. Several respondents felt that instead of providing more metrics we should be focusing on getting investors to better understand what past performance means or improving the past performance disclosure. A respondent felt that we should ban the use of past performance in marketing materials entirely because it was so misleading.

Performance disclosure and communication – our response

We currently intend to consult on new requirements to clarify that, wherever AFMs choose or are required to present their past performance, they must do so against the most ambitious target they set out to investors. For example, an absolute return fund's most ambitious target may be LIBOR +4%. If we bring in such rules, their effect would be to make clear that, where the AFM chooses or is required to display the fund's past performance, it must show the past performance against LIBOR +4%, and not against LIBOR alone.

As set out above we also intend to consult on rules such that where an AFM does not set a specific benchmark, comparator or numerical target return for a fund the AFM must not present past performance against benchmark, comparator or target across regulatory and marketing materials.

We intend to consult on such a rule and/or guidance in due course subject to further consideration and analysis. This will include considering the compatibility with European legislation, such as UCITS and PRIIPs.

We note that respondents have provided suggestions for improving long-term measures of performance. However, in most cases there is little to suggest that disclosing this kind of information to investors is not already possible. We also agree that additional metrics could add complexity, as well as there being cases where they have a more limited applicability for a number of reasons. Therefore we do not intend to mandate the inclusion of any of these additional metrics. However, we encourage providers to continue to consider which communications might be helpful for their investors.

We appreciate that mandating individual client-focused performance would place a significant burden on providers but we also see the potential benefits of doing so. Firms are not prevented from providing information on performance in this way and we are not proposing to mandate this. We continue to see that there may be merits of both the up front and ongoing disclosure of performance against objectives and benchmarks, and this is an area that the working group on objectives could consider.

We continue to believe that it is important that investors receive the message that 'past performance is not a reliable indicator of future

results⁵⁴ and our findings support that this caveat continues to be the case.⁵⁵

We will also continue to consider how past performance disclosure and communication at other points in the consumer journey may affect consumer decision-making and outcomes as part of our work on performance.

For further information on our proposals on performance fees please see Chapter 13.

Other useful metrics that could give investors better insight into future returns

- 12.25** To find measures to help retail investors identify which fund is right for them we asked respondents to consider whether there were any other metrics, indicators or information that could give investors a better insight into likely future returns.
- 12.26** Respondents suggested using new metrics including ESG-related disclosures, stewardship and costs associated with portfolio turnover.
- 12.27** Several respondents felt that greater use of technology, or a new way of comparing and presenting current information would assist investors.
- 12.28** Some respondents cautioned against adding additional metrics as this may confuse the average investor.
- 12.29** Respondents also commented on the effectiveness of disclosure and marketing more generally. They also discussed upcoming PRIIPs requirements to show performance scenario projections.
- 12.30** Several respondents said they used or knew of other metrics that helped assess performance. However, they felt these were unproven, too complicated for retail investors or potentially misleading and so should not be used.

Other useful metrics that could give investors better insight into future returns – our response

Our working group on objectives could consider whether firms should provide investors with more information to help them better understand the returns in relation to objectives. For example, if the firm promotes their ESG ability then they could provide investors with the information necessary to assess this. Our Working Group could consider the usefulness of these kinds of metrics.

54 See COBS 4.6

55 For more information please refer to the interim report. We found that past performance is not a good indicator of future risk-adjusted returns (for example see paragraph 6.46-6.50 of the interim report).



We agree with respondents that, in some cases, additional information is likely to be counterproductive because it could be confusing, especially for less sophisticated investors. Our analysis also supports this. We tend to agree with respondents that focusing on investor understanding of current metrics including objectives and costs is important.

As part of our wider work on firm communications we are consulting on new guidance⁵⁶ to clarify to firms that they can provide investors with additional information as well as the information they must provide in standardised disclosure documents.⁵⁷ We take on board and welcome references to additional metrics and methods of representing information that forthcoming regulatory initiatives will introduce.

We agree with the respondents who noted that technology may offer new opportunities for both presenting and comparing information. Investors are likely to benefit from this, even in cases where this information is covered in current metrics.

We have considered respondents' points about current performance metrics, including past performance disclaimers, in our proposed remedies on performance disclosure.

Persistent underperformance

- 12.31** During the interim report we analysed academic studies which suggest many investors do not switch away from funds with long term underperformance. Our analysis of UK equity data showed some persistent poor performance and that a large number of poorly performing funds are merged or closed.
- 12.32** We asked whether managers should be required to take action when funds are persistently underperforming and what form this action should take. We also asked whether there was a role for the regulator in 'shining a light' on poorly performing funds and what form this should take. We asked respondents to consider any unintended consequences of these options and how they could be overcome.
- 12.33** A few respondents believed that we should play a role in highlighting funds which are performing badly. However, most asset managers and their representatives were against this. They argued:
- there is currently sufficient competitive pressure on asset managers to identify and address poorly performing funds
 - enhanced disclosure remedies, alongside remedies on governance and setting clearer objectives would also help this
 - it is difficult to develop a definition of underperformance which would be suitable for all funds and such a definition would be backwards looking

56 COBS 14.2.1R www.fca.org.uk/publication/consultation/cp17-6.pdf

57 While complying with current rules at all times.

- 12.34** Several respondents saw our role as ensuring that asset managers have appropriate governance in place to effectively review and challenge the performance of funds. An asset manager argued that the role of the FCA should be to challenge fund managers on what action they are taking to address persistent underperformance.
- 12.35** Where respondents believed we should take action on persistent underperformance they argued that our focus should be on enabling investors to identify poorly performing funds through enhanced disclosure. However, they also recognised that that this information should be presented as clearly as possible, as investors might struggle to interpret it.
- 12.36** A few asset managers noted the importance of making sure that funds have clear objectives and that performance against it is measurable to enable investors to identify poor performance.
- 12.37** A legal firm suggested that we should issue guidance on what asset managers should do with poorly performing funds. They argue that it would be impractical to issue rules as the reasons for underperformance vary hugely.
- 12.38** A platform believed that advisors and platforms should be given the freedom to identify poorly performing funds and to suggest alternatives to investors without this constituting a recommendation to them.

Persistent underperformance – our response

Our interim findings showed some evidence of persistent poor performance, but that there is also some self-correction occurring in the marketplace, with asset managers more likely to close or merge funds that perform badly than those which perform well. We have carried out further analysis to understand how effective this self-correction mechanism is. We found that while this self-correction mechanism exists, it does not cover all poorly performing funds and can take a long time to happen. We believe that this evidence suggests that while the market is already addressing this issue to an extent, as some respondents have suggested, this alone is not sufficient for all investors. See Annex 2 for further information.

We acknowledge respondents' concerns about the practical difficulties of the FCA defining poorly performing funds, and the unintended consequences which could occur if we were to directly 'shine a light' on funds with long-term underperformance. We also recognise that some of the other remedies we are introducing might address some of these concerns. In particular, the proposed remedies to improve the clarity of objectives and ongoing disclosure requirements.

We believe that our proposals on clarity of objectives and the use of benchmarks and comparators, along with increasing transparency of cost and charges will enable investors to better understand what their fund is trying to achieve, and monitor performance against any targets. These combined are expected to better equip investors to understand instances of persistent underperformance.

13 Transparency of fees and charges

In this section we provide a summary of the responses and our final recommendations on the single all-in fee and alternative solutions, disclosure of fees and charges for investors and risk-free box profits.

We have considered how some of our concerns in this area may be addressed by upcoming regulation. We propose to:

- improve the way firms communicate fund charges and their impact, particularly in ongoing communications to retail investors, including supporting the single all-in fee being brought in by MiFID II
- encourage increased transparency and standardisation of costs and charges information for institutional investors
- consult on requiring firms to return any risk-free box profits to the fund
- consult on rules so that performance fees are only permitted above the fund's most ambitious target and consider whether further policy action on performance fees is appropriate

Requiring clearer communication of fund charges, including a single all-in fee, and the impact at the point of sale in ongoing communication to retail investors

- 13.1** In the interim report we expressed concern that charges might not always be visible to investors, that investors might not pay sufficient attention to charges or understand what they represent. Charges can be difficult for investors to understand, particularly when they are expressed in percentage terms. The majority of respondents to the interim report agreed that increased transparency and comparability of fees and charges might encourage investors to be more price-sensitive.
- 13.2** We received a number of suggestions from respondents about how we could proactively encourage retail investors to focus on the impact which charges have on their investments and encourage price competition. These included, for example, using an obligatory risk warning about the impact of charges and representing the charge graphically. There was also some support for expressing the charge in terms of pounds and pence, rather than a percentage.
- 13.3** In discussing whether there are alternative remedies or pricing models that would encourage asset managers to control charges the majority of responses focused on the disclosure of charges. Respondents said they would welcome additional work to establish what methods would be most effective.

13.4 A number of respondents suggested that more detailed information should be made available to retail investors. However, some felt that one single all-in fee would help improve clarity of information, which they argue is more important than full transparency.

A single all-in-fee

13.5 We found that firms do not disclose some charges, particularly transaction costs, to investors before they make their investment decisions. Additionally, as charges are estimated in advance, investors bear the risk of the actual charges being different from the fund manager's advance estimate. Investors currently bear this risk, despite having no ability to control any differences between the estimated and actual charges taken from the fund. We consider that these issues are likely to contribute to limited price competition for actively managed funds and to asset managers being weaker at controlling more complex costs.

13.6 To address these concerns, we proposed introducing a single all-in fee to increase the visibility of all charges taken from the fund and impose more discipline on overspend relative to charging estimates. We proposed four ways that this single all-in fee could work:

- a.** the current OCF becomes the actual charge that is taken from the fund
- b.** the current OCF becomes the actual charge, with the managers providing an estimate of any implicit and explicit transaction costs⁵⁸
- c.** there is a single charge which includes all charges taken from the fund, including both implicit and explicit transaction costs, but with an option for 'overspend'
- d.** there is a single charge which includes all charges taken from the fund, with no option for overspend

13.7 We asked for views on:

- the likely effectiveness and proportionality of the four ways that the single all-in fee could work, as well as any unintended consequences of any of them
- whether the scope of a single all-in fee should be limited to retail investors or be extended to other types of investor
- whether there are better alternative remedies or pricing models that would encourage asset managers to control the charges taken from funds

13.8 Most respondents agreed that more transparency about charges, including transaction costs, could help investors compare prices and access information about the true cost of their investments.

13.9 However, some warned against investors becoming too focused on charges or not understanding the charges. A number of respondents argued that while charges are important they are not the only thing that investors should consider. Several respondents stated that any change to fee structures and disclosures should include a

58 The cost to trade, which can be explicit (e.g. taken as a fee or commission) or implicit (e.g. the difference between the bid and offer prices of a security)



careful education process to ensure investors understand what the charge represents and how to interpret it. Respondents noted that, where they applied, exit fees, performance fees and tiered fee structures would all need to be included in true single all-in fee representations.

- 13.10** Several respondents raised the high cost and practical complexity of providing transaction costs as part of a single all-in fee. They also pointed out the importance of standardising how transaction costs are measured to ensure that these are comparable. Many asset managers argued that transaction costs are very different to management charges in nature and also cannot be predicted accurately ahead of time. Respondents raised questions about whether providing the level of transaction costs in isolation would be meaningful to investors and raised concerns about the impact this could have on asset managers' incentives.
- 13.11** Respondents also raised concerns that subsuming transaction fees into a single all-in fee could create perverse incentives for asset managers. They felt this could lead to a conflict of interest as asset managers might not be incentivised to trade even where this would be in the best interests of investors.
- 13.12** Several respondents said that bundling all the charges and costs into one figure might make it harder to compare funds, unless a breakdown of the component costs is also provided. Respondents also raised concerns that including all costs and charges in one figure could harm UK fund competitiveness where headline fund charges are compared with headline charges in other jurisdictions, as UK fund fees would appear more expensive.
- 13.13** Several respondents suggested that a single all-in fee should include all the costs through the investment chain, including distribution costs.
- 13.14** Other respondents thought this remedy was unnecessary. Several asset managers said that a single all-in fee is not required as the manager has an adequate incentive to keep costs under control, because investors already consider net performance and incurring these costs would act as a drag on performance.
- 13.15** Some respondents argued that better governance would control costs more effectively.
- 13.16** Of those who expressed a preference, most asset managers and their representatives preferred option B. This option makes the OCF the actual charge and provides investors with an estimated transaction cost. Although some respondents argued that there was not sufficient justification for requiring the current OCF to be an actual cost rather than an estimate and suggested that this could lead to higher overall costs.
- 13.17** We asked respondents whether there are alternative remedies or pricing models that would encourage asset managers to control the charges taken from funds. The majority of the responses highlighted metrics that are currently undisclosed, or metrics that are currently disclosed but could be presented in a more accessible way.⁵⁹ We also received specific suggestions about disclosing of transaction costs including requiring providers to self-impose a fee cap and disclosing portfolio turnover rates.

59 The metrics suggested were similar to those included in Chapter 12.

Requiring clearer communication of fund charges, including a single all-in fee, and the impact at the point of sale in ongoing communication to retail investors – our response

There are changes due to come into place at the start of 2018 under PRIIPs and MiFID II. The new provisions under MiFID II go beyond what is currently required and will introduce new requirements for firms to provide aggregated and on-going information on all costs. The new provisions require that all costs and charges must be shown as a single disclosure, including asset management charges, indirect costs such as transaction costs, and intermediary charges.

Firms will, where applicable, need to provide the aggregated information to the client on a regular basis, at least annually, for the lifetime of the investment. Firms must also provide an itemised breakdown of costs when the client requests it. These changes will give consumers greater understanding of the full costs and charges of the investment products and services that they are buying. Both PRIIPs and MiFID II will require firms to calculate and disclose indirect costs such as transaction costs and to present charges as a cash amount in cost disclosure documents. This will allow the client to understand the overall cost as well as the cumulative effect on the return of the investment.

Whilst we consider that these changes will provide investors with greater clarity about the charges they are likely to face, we think that the way in which this information is presented to investors will have an impact on how the information is used. As part of the Smarter Consumer Communications initiative, we have undertaken work to improve consumer communications and enable informed consumer engagement with financial services products more generally.⁶⁰ Therefore we are testing ways to improve the effectiveness of any forthcoming disclosure in order to understand the role of the prominence and formatting of charges information in encouraging investors to focus on the impact charges have on their investments and enabling effective price comparison. This will inform the development of any future remedies in this area.

To supplement existing and incoming legislation we are also considering whether to consult on guidance in areas such as the wider use of pounds and pence disclosure on other information sources. As part of this work we will also consider the benefits to consumers of consistency between point-of-sale and on-going disclosures.

Reforms under MiFID II also mean that there will be greater obligations around best execution. The new, more comprehensive best execution provisions in MiFID II will also strengthen the content and quality of disclosure to clients. Asset managers will be expected to step up their efforts to obtain the best possible result for their clients when placing orders with brokers on behalf of their clients. They will also be required to provide greater transparency on execution quality including the top five entities to which they sent orders for execution in the preceding



year.⁶¹We expect that the introduction of these new reporting and disclosure requirements will provide investors and other third parties with valuable tools that will reduce information asymmetries by facilitating better scrutiny of execution quality and order routing decisions. There is also an expectation that these requirements will increase firms' monitoring of their own execution quality.

Additionally, the governance reforms we are proposing are intended to ensure that governance bodies act in the best interests of investors, including by considering value for money. We will continue to monitor the effectiveness of the remedies in this space.

Performance fees

- 13.18** A small number of respondents said there were potentially positive effects of performance fees as these can help to better align investor and asset manager incentives.
- 13.19** A small number of respondents discussed the differences between incentive structures in symmetric and asymmetric performance fee models. Some respondents proposed symmetric performance fees, as they argue this aligns incentives between the manager and the investor.⁶² One respondent suggested a new kind of symmetric performance fee where AFMs would owe investors a penalty payment when they underperform their target.

Performance fees – our response

Although we have specific rules for the introduction and disclosure of fund performance fees, and guidance on how they are calculated, we do not currently prescribe exactly which operating models the AFM may or may not use. We say only that the fee must not be unfair to unitholders or materially prejudice their interests. As we described in our interim report we have identified that some AFMs charge performance fees for achieving a level of return below the most ambitious target they hold out to investors, for example in absolute return funds. We are considering consulting on rules so that performance fees are only permitted above the fund's most ambitious target (consistent with our proposals on performance reporting set out in Chapter 12). We also found some performance fees were charged on gross returns (before ongoing charges) and therefore we intend to consider whether performance fees should only be permitted above the fund's most ambitious target after ongoing fees.

A 2016 IOSCO Report indicated that some jurisdictions have specific rules to prevent inequitable charging with regard to fund performance fees. The report suggests that rules that require losses are offset before further performance fees can be charged could be

61 More details on the MiFID II best execution provisions and our implementation of them in the UK, including our extension of them to collective portfolio management by UCITS firms, are contained in CP16/29.

62 A symmetric performance fee is where the manager shares some proportion of both the up and downside of fund performance.

appropriate.⁶³ We are supportive of fee structures that align incentives between investors and asset managers. We will further consider whether additional policy action is required to make UK domiciled funds' performance fee structures more equitable and as part of this we may consider those asymmetric fees which do not align investor and manager incentives.

Requiring increased transparency and standardisation of costs and charges information for institutional investors

13.20 As set out in the interim report:

- It has been difficult for pension trustees to get information on transaction costs. As we are currently consulting on a standard methodology for how transaction costs should be calculated for disclosure to trustees and IGCs, we do not consider further remedies are needed to make transaction costs transparent to trustees.
- For segregated mandates there is no consistent definition of the annual management charge with managers including different items within this charge. However, trustees could request for charges to be disclosed in a comparable format as part of the tendering process.
- Information about charges is often unclear for those investing through more complex fund structures such as hedge funds and private equity funds. While our market study did not include private equity funds we heard comments that this is a particularly opaque part of the asset management sector. We will consider whether any remedies should apply in this part of the sector.

These issues are likely to contribute to asset managers being less effective at controlling complex costs, as well as limiting institutional investors' ability to drive competition and get value for money.

13.21 Disclosure of charges is regulated and standardised for retail investors, but is currently less so for institutional investors. Institutional investors would like better information on costs and charges, though the ability to negotiate discounts means publically available information has limited value. A small number of respondents cited examples of poor practices in invoicing and there were general concerns raised that asset owners are either not scrutinising invoices properly or not able to do so due to a lack of appropriate information.

13.22 The vast majority of respondents were in favour of greater transparency of costs and broadly felt that investors would benefit from increased disclosure. We found two themes in responses. First, that trustees, especially of large funds, have not requested any further disclosure and already receive all of the data they require. Second, that while cost disclosure is desirable, smaller investors may not have the expertise of bargaining power to use it to drive down cost. Several respondents said that the sophistication of institutional investors is often overstated.

63 IOSCO FR09/16 Good Practice For Fees and Expenses of CIS, August 2016, paragraph 35.



- 13.23** Regarding the type of disclosure, many respondents referred to existing standards (MiFID, GIPS, PRIIPs) or to standardised templates created by various bodies (Investment Association, the Local Government Pension Scheme, the Transparency Taskforce and the Institutional Limited Partners Association). Responses tended to distinguish between charges for management, third party charges, transaction costs and performance fees, arguing they have distinguishing characteristics that call for different treatment.
- 13.24** Respondents generally thought that all costs need to be included in a template to make it worthwhile. However, many respondents raised concerns over how to balance consistency and transparency with simplicity and the ability to deliver more complex pricing structures to funds where this is appropriate. Some asked us to either create our own template or issue guidance on how to comply with another template.
- 13.25** Responses on the likely cost of any disclosure varied significantly. Many claimed that cost is likely to be minimal since asset managers already have this information. However, other respondents suggested that there could be a material cost and that this must be balanced against the requirements of any disclosure remedy. At least one respondent suggested that further disclosure could lead to further price clustering, though they acknowledged that this could lead to prices falling.
- 13.26** All responses on the scope of disclosure felt that the remedy should cover all funds, including private equity and hedge funds.

Institutional disclosure – our response

We agree with the large number of responses that said the level of disclosure of costs and charges could be improved. Responses from institutional asset owners indicated that they did not always have access to a detailed breakdown of costs incurred.

MiFID II is introducing significant changes in the area of costs and charges disclosure for institutional investors who appoint an asset manager to manage a segregated mandate. It requires information on all costs and associated charges to be provided to clients in good time before the client enters into a contract, and an account of the actual costs to be provided on at least an annual basis. In response to this new regulatory requirement, there are industry-led attempts to develop greater cost transparency for institutional investors.

We consider that the information required by MiFID II will give institutional investors a clear understanding of the costs and charges that they are incurring. If this information is delivered within a well-designed template, it could facilitate more effective competition. We agree with respondents that design principles for any template should ensure that templates are free from jargon, accessible and easy to understand and that any definitions used in the templates should be clear and consistently used. We also agree that it is unlikely to be helpful if most costs are disclosed under headings such as 'other.' A well-designed template should allow investors to compare charges between providers and have a standard set of information which they might expect to receive from any provider or potential provider.

Given the concerns raised previously about the resource constraints on some institutional investors, and smaller pension funds in particular, we think in order for this disclosure to be effective there needs to be a balance between simplicity and transparency. However, we would expect that in some cases, this will lead institutional investors to ask questions and seek further information from their asset managers. Where this is the case, we would expect that asset managers would respond to these queries in a timely manner.

While we consider that there would be benefits to asset managers in having a single disclosure template to complete, we do not see any standardised disclosure as a maximum level of disclosure. Where investors want to agree bespoke disclosure arrangements or additional pieces of disclosure with their asset managers as part of the investment management agreement or as part of their ongoing relationship, we do not consider that any standardised template available should prohibit this.

Nevertheless, irrespective of the use of any standardised template, the requirements of MiFID II mean that firms should provide accurate information on costs and charges, and inaccurate information, whether or not provided within a template, would be a breach of the MiFID II rules⁶⁴, against which we could take supervisory or enforcement action.

Most respondents suggested that compliance with one of several templates would help solve the problems we identified. They noted the use of the LGPS voluntary Code of Practice which was developed by the LGPS Board to comply with the revised Chartered Institute of Public Finance and Accountancy accounting guidance on fee transparency. We are also aware that the IA is consulting on a standard template that uses a similar design structure. Respondents also referred to the development of a more detailed disclosure by the Transparency Task Force.

We welcome the work that has been done on developing templates and recommend that both industry and investor representatives agree a standardised template of costs and charges. We propose to ask an independent person to convene a group of relevant stakeholders to develop this further, for both mainstream and alternative asset classes, where appropriate. Following this, we will work with these stakeholders to consider whether any other action is necessary to ensure that institutional investors get the information they need to make effective decisions.

64 See Article 24(3) of MiFID II which provides that “[a]ll information addressed by the investment firm to clients...shall be fair, clear and not misleading...”.

Box management practices

- 13.27** We found that some sources of revenues for the asset manager are associated with buying and selling funds and are not transparent to investors. This included where risk-free box profits are made. We found that while most firms do not retain them, for those that do, risk-free box profit revenues can be significant.
- 13.28** At interim report stage we noted that we were considering changing our rules to ensure that any risk-free box profits from the matching of flows in and out of dual priced funds are used solely for the benefit of the fund, and cannot accrue to the asset manager.
- 13.29** A number of respondents commented that it was not fair that fund managers could profit from the matching of buyers and sellers in fund units, and investors did not know that this practice was occurring. Some respondents thought that box profits contravened the principle of treating customers fairly.
- 13.30** Respondents agreed that investors are unable to scrutinise box profits. This is because it is not possible to tell, either from forecasts or after the event, whether the price any one customer has paid for their units covered the cost of transactions or contributed to the manager's box profit.
- 13.31** Some respondents thought that box management should be an issue considered by fund governance bodies.
- 13.32** Most respondents said that the box profits should be passed on to the fund rather than to the fund manager. A small number of respondents noted that this on its own would not solve the issue of some investors paying a spread that was not being used to cover the cost of the associated trading motivated by their purchase or sale. However, respondents noted practical issues with alternative solutions.
- 13.33** A small number of respondents stated that the matching of units in the box occurs outside the fund and does not damage the fund's performance since investors would pay the same price regardless of where the risk free profits went. They said that passing the profits on to the fund would artificially inflate the fund's performance.
- 13.34** Some respondents also discussed box profits (those that are as a result of positions held 'at risk') in their submissions and said that dual priced funds which use a manager's box with a stock of units to actively buy, sell and hold units can provide benefits to investors by offering a narrower spread. This reduces the costs of entry and exit while still protecting existing unitholders from dilution. This methodology also means that, unlike a single swinging-price fund, the fund manager does not have to switch the pricing basis of the fund, so reducing price volatility. In exchange for these services they said that the manager bears liquidity risk and market risk on the stock of units. Respondents also stated that there was a cost to administering flows which could be met by the fund, rather than the manager if risk-free box profits were to be banned.

Box management practices – our response

We agree that dual pricing can benefit existing investors, and do not propose to stop firms from operating dual priced funds. We agree with the majority of respondents who suggest that risk-free box profits should not accrue to the manager. We therefore propose to prohibit retention of these profits. We think that the benefit of any risk-free box profits should accrue to the fund as the most pragmatic means to end the practice. We set out the proposal in CP17/18, published alongside this report.



14 Other remedies relating to retail investors and retail intermediaries

In this section we provide a summary of the responses and our recommendations on share class switching and retail distribution.

We are proposing to:

- consult on removing barriers for firms to move investors to cheaper share classes without express consent where this is in investors' best interest
- launch the Investment Platforms Market Study

Making it easier for retail investors to move into better value share classes

14.1 Firms told us that where they create new share classes (typically in response to the RDR) they find it difficult to switch investors to these new, cheaper share classes even if this would be in the best interests of investors. We identified a number of reasons why investors may remain in a share class despite a cheaper alternative being available and we considered the scenarios in which remedies would enable investors to move to cheaper share classes. We focused proposed remedies on scenarios where investors remain in more expensive pre-RDR share classes, but where commission payments have been turned off, and where those share classes continue to pay trail commission.

14.2 We therefore asked:

- which scenarios our remedies should be focused on
- what the most proportionate and effective way of moving investors into cheaper share classes would be
- what the estimated cost of moving investors to cheaper share classes would be and how these costs would arise
- any potential unintended consequences of remedies in this area

14.3 Respondents had various suggestions for making share class switching easier:

- Several respondents suggested removing the opt-in requirement to seek consent from investors before moving them into a different share class where they would be better off. Respondents also suggested replacing the opt-in requirement with an opt-out style requirement. Respondents felt that this should be considered especially in cases where the investors are not paying trail commissions. Respondents argue that this would be more straightforward for investors, from whom consent is often difficult to obtain, and make it cheaper for asset managers to implement bulk switching. They noted that transfers would have to be managed in a way that did not orphan customers from any advice or service they were still receiving.

- Several respondents requested the FCA reconsider the option of introducing a sunset clause to end all trail commission that is still being paid on advised share classes bought before 31 December 2012, on the basis that they do not think these customers are in receipt of on-going advice. They also cited the lower costs to firms from running smaller ranges of funds. A respondent noted that they had a desire to unilaterally turn off all trail commission across its fund range, as some competitors had previously done, which would put all customers in the cheapest share class. Although respondents stated that there was no legal impediment to reducing fees without consent provided the prospectus allowed this, firms indicated that there was appetite for clarity from the regulator that unilateral cessation of trail commission payments in this way was an acceptable course of action.
- Several respondents were in favour of investors being given more information when cheaper share classes were available, either from distributors or directly from the asset manager. Respondents noted that in itself this was not likely to be sufficient to drive significant numbers of customers to switch share classes.

14.4 A small number of respondents noted that if investors were in effect forced to redeem their funds in order for their manager to move them from one share class to another then the tax implications should be considered, particularly for overseas investors. A respondent suggested that share class consolidation (keeping the monies within the same fund) would prevent crystallising a tax liability. A respondent suggested engagement with HMRC to prevent crystallising tax liabilities in these cases.

Share class switching – our response

In response to concerns raised by respondents we propose to modify and re-issue our previous guidance (FG14/4) on dealing with unresponsive unitholders as part of CP17/18. We will clarify that the AFM can undertake a mandatory conversion, if the required conditions are met.

In response to respondents' requests to reconsider our approach to trail commission, we are asking for any information that firms have about trail commission payments to advisers on share classes sold prior to 31 December 2012, with the view to feeding any findings into future work. Further information can be found in CP17/18.

Further FCA work on distribution in the retail market

14.5 During the interim report we considered the following questions:

- What impact do platforms have on fund charges?
- What impact do platforms have on the total cost of investment?
- Do platforms create barriers to asset managers gaining routes to market?



- What impact does the financial advice market have on competition between asset managers?
- Do fund governance bodies consider value for money on behalf of investors?

14.6 At interim report stage we found that:

- Investors are not always readily presented with a choice of passive funds through platforms and rating providers
- There are some barriers to switching platforms
- Platforms can secure discounts on fund charges but this practice is not widespread. It is not clear that retail investors benefit fully from the buyer power and economies of scale available to platforms.
- Investors can incur a range of different platform charges and incentive payments, potentially making it difficult to understand the full cost of investment
- Platforms represent an important route to market for new funds and managers, and perform useful due diligence
- Within the advice market, vertical integration of advice, platform and fund management in some firms, the growth of model portfolios and the role of third party rating providers all raise questions about competition dynamics and value for money.

Our analysis was based on a small number of execution only platforms.

14.7 Respondents were generally supportive of further work to examine competition in retail distribution. Respondents stated that:

- we should consider the entire value chain when considering the asset management market and value for money in particular
- distribution costs and intermediary fees are often in excess of fund manager fees, and that these fees have gone up after the introduction of RDR
- several vertically integrated groups have profit margins in excess of fund managers' profit margins
- conflicts of interest in the adviser business model, especially when increasingly integrated with platforms and asset managers, were potentially creating distortions in the retail distribution
- regulation including the RDR and the definition of regulated advice may result in suboptimal outcomes for investors⁶⁵

14.8 Respondents also raised issues with model portfolios including what they perceived as poor value for money as a result of additional layers of fees, tax implications that are not made clear to investors and poor transparency and comparability for investors.

65 We continue to work on the FAMR recommendations, for example see www.fca.org.uk/publication/guidance-consultation/gc17-04.pdf

Respondents also raised concerns about asset managers paying a third party rating firm in order to obtain allocation into a model portfolio, and suggested that this is a conflict of interest which potentially leads to poor outcomes for consumers.

14.9 Although there were some arguments stating that the platform market is competitive, the majority of respondents appear to have concerns regarding:

- complexity of fees and charging information available on the platform and the usefulness of this information
- the effect of potential conflicts of interest on the promotion of products and the design of solutions
- competitive pressure, particularly:
 - economies of scale and the overall cost of platforms
 - barriers to switching

14.10 We received several comments about the effectiveness of platforms in helping investors make informed choices. Several respondents expressed concerns regarding the complexity of costs and charges and therefore the potential for a lack of investor understanding of these. Respondents also raised concerns about how platforms are presenting information which is important to investors for decision-making such as the relative cost of in-house funds. Respondents suggested that further investigation is warranted into the extent to which platforms promote different funds and particularly those that are developed in-house and any differences between active and passive fund promotion.

14.11 Some respondents expressed concerns that consumers may face barriers to switching platforms. This is due to the cost and delay of moving from one platform to another and where platforms do not offer access to all the same funds. Some called for a full standardisation of the switching process.

14.12 Respondents suggested that platforms do attempt to use their buyer power when negotiating with fund managers and are successful to some extent successful. Respondents highlighted the lower prices available for the same products across different platforms. However respondents also raised concerns about whether the benefits of discounts achieved by platforms were partially offset by the high platform fees incurred by investors. Whilst some respondents argued that platform pricing is very competitive, others argued that total pricing levels are too high and that economies of scale were not passed onto investors.

14.13 Some respondents questioned whether platforms offer value for money. Respondents raised concerns on adviser platforms in particular as they are used by advisers but paid for by investors. However, due to the way the end investors pay, the constituent costs may not be clear.



Distribution in the retail market – our response

The responses confirmed our view that further work is warranted to ensure that investment platforms demonstrate and promote effective competition in the interests of consumers. To consider whether the issues apply across the market, we will be undertaking the Investment Platforms Market Study.

The study will consider how 'direct to consumer' and intermediated investment platforms compete to win new and retain existing customers. The study will explore whether platforms enable retail investors to access investment products that offer value for money. The Investment Platforms Market Study will allow us to understand the causes of any competition problems in this market and assess what we can do to improve competition between platforms and improve consumer outcomes.

Advisers are being considered as part of the wider ongoing work on the package of remedies from the FAMR. The FAMR recommendations update was published in April 2017 and the review of the outcomes from FAMR is expected in 2019.

15 Other remedies relating to institutional investors and investment consultants

In this section we provide a summary of the responses and our recommendations on pension pooling, pensions and trustee-related issues, and investment consultants.

We are proposing to:

- recommend that DWP remove barriers to pension scheme consolidation and pooling
- consult publically on our provisional view to reject the proposed undertakings in lieu received from firms to address the concerns we raised previously
- recommend that the Treasury extend the regulatory perimeter to include all aspects of investment consultancy services

Exploring the potential benefits of greater pooling of pension scheme assets

15.1 We found that smaller occupational pension schemes are less likely to be able to exert pressure on asset managers because:

- there is some relationship between size and investment expertise and resources, with smaller pension schemes generally having fewer resources for governance and monitoring the performance of their asset managers and advisers.
- larger pension schemes are typically more attractive to asset managers, allowing trustees to negotiate lower fees per pound under administration

15.2 We asked for feedback on:

- whether there are ways parts of the institutional demand side (DB trust, DC trust and DC contract-based schemes) could more effectively pool assets
- to what extent pooling would result in better outcomes for investors
- whether there are logistical challenges involved in pooling assets and how we could overcome these.

15.3 Many respondents supported pooling in principle, citing many potential benefits, including:

- increased buyer power
- more professionalised decision making and/or improved governance structures
- increased ability for trustees to focus on strategic/asset allocation decisions



- greater access to investments which would otherwise not be available to smaller schemes
- greater access to a broader range of skills

15.4 Several respondents noted initiatives in pensions and in other jurisdictions from which lessons may be learned. According to respondents significant barriers to pooling appear to exist, particularly for DB pension schemes. These include, for example, existing complex requirements about pensionable salaries and responsibilities of trustees and sponsors. Respondents also highlighted that pooling of (particularly) DB schemes may not always be desirable for some members and there are a number of challenges to overcome before this can work effectively in practice, including different liability profiles and funding ratios.

15.5 Moreover, respondents have also stressed that there are existing ways to effectively pool assets, including fiduciary management, and this offers some of the main benefits of asset pooling. Other methods respondents referred to that effectively pool assets include master trusts, group personal pensions, institutional platforms and Authorised Contractual Schemes.⁶⁶

15.6 Respondents felt that our work had not distinguished clearly between merged schemes, shared governance, aggregated vehicles and comingling assets. Respondents felt that the merits and demerits of each of these methods of asset pooling should be considered separately, particularly when considering whether the benefits of pooling outweigh the costs.

Pension pooling – our response

As previously outlined in the interim report, we have found that smaller pension schemes generally have fewer resources for governance and monitoring the performance of their asset managers. We have received many responses corroborating this point and suggesting that there would be a variety of benefits to asset pooling through considerable economies of scale. For further information on our findings as a result of additional work on segregated mandate pricing specifically, please see Annex 3.

Nonetheless, although size can be a determinant of outcomes, it is not the only factor and small schemes with expertise and good governance can secure positive outcomes.

For DB schemes, we agree that some schemes might be able to benefit from pooling through lower fees and wider choice. However, there are barriers to DB pension scheme pooling, in relation to complex rules concerning changes to existing benefit structures as well as the responsibilities on trustees and sponsors and certification requirements. Some stakeholders also told us that greater transparency and reporting, for example, explaining in their annual scheme report why they didn't consolidate could be an effective measure. We have found that removing

⁶⁶ An Authorised Contractual Scheme is an umbrella fund that offers a range of sub-funds, which provide participating authorities with access to a range of asset classes that they require to implement their investment strategies.

some of these barriers could encourage the practice of asset pooling, allowing smaller pension schemes to benefit from economies of scale and exert greater pressure on asset managers. This would require changes to legislation and the issuing of further guidance to trustees.

For DC schemes there remain some benefits from pooling through merging schemes, as bigger schemes can often negotiate lower management charges.

In December 2016, DWP published a Call for Evidence which sought views on how processes for DC scheme bulk transfers without member consent might be simplified, to remove a key barrier to DC scheme consolidation. The Department continues to consider ways that it can simplify scheme consolidation and allow pension scheme scale to develop.

Moreover, despite members already buying units in contracts linked to pooled funds, we have found that economies of scale from pooled funds are not passed on to investors in the same way that asset pooling might enable.

We also agree that there are different ways of pooling assets including more structural solutions such as merging schemes and comingling assets, as well as solutions such as sharing governance or pooling instruments or vehicles. We agree with respondents that the advantages and disadvantages of these options should be considered separately. Addressing some of the identified concerns we have in the area of fiduciary management could also be an effective way of bringing about the associated benefits of asset pooling.

Overall, we agree with some respondents who stated that there are existing opportunities for asset pooling and, while we recognise the potential benefits of asset pooling, we do not think it's necessary to make asset pooling mandatory for DC or DB schemes, especially in light of the upcoming changes.

We therefore recommend that the DWP continues to explore the possibility of removing some of the barriers to pension scheme consolidation and pooling. We will work with DWP to explore the feasibility of this further.

Measures to improve the usefulness and comparability of information used by trustees

15.7

We found that information presented to trustees about the performance of their investments is often presented in a format that is difficult for investors to understand and engage with. In the interim report we encouraged stakeholders to consider the best format for presenting performance information to trustees and IGCs, noting that these consist of a mix of lay and expert members.



15.8 We asked respondents whether there were better ways for information to be presented to trustees, particularly member nominated trustees, in order for them to assess the performance of their scheme and how this could be achieved. We also asked what format should any simplified and comparable disclosure take and who should be responsible for providing the information.

Usefulness and comparability of information provided by trustees

15.9 Respondents were generally supportive of improved transparency and comparability where possible. A small number of respondents referred to existing standards or principles in other parts of the pensions market that could be mirrored to improve outcomes for trustees. For example, one noted templates used for reporting statements for trustee boards and IGCs created as an aid to focus on the key information that should be reported to members. Several respondents felt that guidance or communication of 'best practices' would help trustees more effectively compare, assess and select fiduciary managers. Respondents emphasised that any initiative would have to be based on sound principles and help trustees to implement a robust governance framework to support their decision-making, monitoring and oversight mechanisms.

15.10 Respondents generally supported measures to improve trustee experience, expertise, skill and professionalism. This could include some kind of guidance. Respondents also referenced ongoing work by the The Pensions Regulator (TPR) as part of the 21st Century Trusteeship project.

15.11 Some respondents felt that the interim report unduly focused on the fact the trustees rely too heavily on the advice given by investment consultants. Respondents agreed that issues with expertise could leave trustees exposed to potential exploitation when dealing with investment consultants, although they also noted that investment consultant input could be part of the solution to a lack of trustee expertise.

15.12 Generally there was support for improvements in governance, which respondents felt improved outcomes. This also included monitoring and reviewing decisions, potentially with independent advice or support.

The usefulness and comparability of information provided by trustees – our response

We agree with respondents that lack of information is an issue and increased transparency for trustees would be beneficial. We deal with these issues in our initiatives to improve institutional disclosure in Chapter 13.

We agree with respondents and support measures to improve trustee experience, expertise, skill and professionalism. TPR produces guidance for trustees of occupational pension schemes. This gives practical information and examples of approaches trustees can take to meet the standards set out in its codes of practice. For example, it has recently published new investment guidance for trustees of both DB and DC schemes.⁶⁷ TPR also provides a free, online learning programme to help

⁶⁷ DB investment guidance can be found at www.thepensionsregulator.gov.uk/guidance/db-investment.aspx and DC investment guidance can be found at www.thepensionsregulator.gov.uk/trustees/investment-management-in-your-dc-scheme.aspx

trustees meet the legal requirements for knowledge and understanding. This includes training on DB and DC scheme investment.⁶⁸

At the interim report stage, we suggested that it may be the case that trustees rely too heavily on advice given by investment consultants in some circumstances. While investment consultants play an important role in this market, we still consider that some trustees are heavily reliant on the advice provided by investment consultants and frequently feel unable or unwilling to challenge that advice. We consider that improvements in the ability of clients to assess the effectiveness of the advice provided by investment consultants will improve competition for investment consultancy services, to the benefit of end clients.

Trustee disclosure of costs and charges

- 15.13** As part of the interim report we asked whether there would be unintended consequences if trustees were required to publish costs and charges. Both trustees and IGCs are currently encouraged to report cost information in as full a way as possible to scheme members. We could build on these requirements so that trustees and IGCs have to publicly report on an annual basis using a prescribed template. We could also recommend requiring DB schemes to include this information as part of their annual report. We welcomed views on the merits and feasibility of such an approach.
- 15.14** There was some support for disclosing cost and charges information at a scheme aggregated level as this could aid comparison. However some respondents felt it is unclear how this disclosure would differ from the pound and pence disclosure that is already required.
- 15.15** Reservations raised mainly related to the nature of the information to be disclosed including its potential confidentiality or commercial sensitivity status, as well as the inadvertent effects that this disclosure might have on the status of the fund in other jurisdictions.
- 15.16** A number of respondents raised concerns that if trustees were required to publish costs and charges, this would cause trustees to focus disproportionately on costs to the detriment of other relevant metrics.
- 15.17** Finally, respondents were also concerned that this could lead to asset managers being reticent to offer special deals, discounts or rebates in the knowledge that they might be disclosed and forced down to this price level by other clients, and this could harm negotiating power for some investors.

Trustee disclosure of costs and charges – our response

In October 2016, we published a consultation proposing rules and guidance to improve the disclosure and standardisation of transaction costs in workplace pensions. We are proposing to place a duty on asset managers to disclose aggregate transaction costs to pension

68 trusteetoolkit.thepensionsregulator.gov.uk/



schemes that, directly or indirectly, invest in their funds. We have also proposed that asset managers provide a breakdown of transaction costs on request with the total broken down into categories of identifiable costs (which could include specific costs such as taxes and securities lending costs). For further information on our proposals on institutional disclosure please see Chapter 13.

Section 44 of the Pensions Act 2014 will place a duty on us and the DWP to require the disclosure and publication of information about transaction costs in DC workplace pensions. We will, in due course, consider the legal measures needed to meet the duties.⁶⁹ As part of its work on the Green Paper, DWP will also work with us to explore the benefits of extending these requirements to DB schemes.

The aim of requiring trustees to publish costs and charges data was to empower pension schemes to access the information they need to make effective choices. We have considered this proposal in light of our other remedies, including increasing asset manager disclosure and DWP's proposed disclosure to DC scheme members. We believe that these will deal with the issues of comparison and transparency that we identified. As a result, we feel that any additional general disclosure by trustees is probably unmerited at this stage, given the burden on trustees and the potential unintended consequences of such public disclosure.

Requiring greater and clearer disclosure of fiduciary management fees and performance

15.18 We found that pension trustees find it difficult to scrutinise the performance of their fiduciary manager because:

- there is very little public reporting and scrutiny of fiduciary management fees and performance, making it difficult for investors to assess the performance of fiduciary managers and compare them, both at the point of sale and on an ongoing basis
- fees and charges disclosure by fiduciary managers is not consistent and comparable. The lack of transparency is likely to make it difficult for pension trustees to manage conflicts of interest when investment consultants also provide fiduciary management, leading to poor outcomes

15.19 We asked for views on:

- ways to provide trustees with clearer information about the charges and performance of fiduciary management
- what information on fees and performance information should be made public and how to benchmark the performance of fiduciary managers

⁶⁹ www.fca.org.uk/publication/consultation/cp16-30.pdf

- what the unintended consequences of enhanced disclosure are and how can we overcome them
- what the likely effectiveness and proportionality is of guidance to trustees on these issues
- whether there are better alternative remedies that we can put in place to empower trustees in their decision making
- what any guidance from TPR/FCA to trustees could usefully cover

15.20 Our interim report considered fiduciary management fees and performance to be one of the most unclear parts of the asset management industry. Many respondents agreed with our view, and that improvements in this area are required to help trustees understand the services and the associated fees and performance.

15.21 A number of investment consultants felt that the presentation of fiduciary fees and charges could be improved. Suggestions included unbundling of fiduciary management fees so that the proportion of fees going to the asset manager, the fiduciary manager and any other components are clear to investors. Additionally, respondents noted that there was a lack of consistency between different fiduciary management offerings and that consistent disclosure would be helpful for investors to compare providers.

15.22 A number of respondents, including investment consultants, had a wide range of views on how fiduciary performance information should be presented to investors. Respondents suggested various methods for presenting information to investors, though several cautioned against the creation of a public performance composite as they felt that benchmarking in this way may begin to drive poor behaviours within firms or may lead to inappropriate comparisons being made. Several respondents referenced industry-led initiatives to promote a standardised performance methodology. Some trade bodies believe a similar standard to GPS could be beneficial. Many respondents considered improved scheme specific information would better serve trustees

15.23 Several respondents considered that trustee knowledge and/or experience was an issue. To help trustees understanding, some respondents considered that TPR is best placed to deliver guidance in this area.

15.24 Several respondents stated that the role of adviser and fiduciary manager should be separated. Some respondents argued that advice should be taken from an independent party before appointing a fiduciary manager to prevent suffering the effects of conflicts of interest. Respondents also provided suggestions more generally to improve and formalise a tendering processes.

Requiring greater and clearer disclosure of fiduciary management fees and performance – our response

We agree that more can be done to improve fiduciary management reporting and welcome suggestions raised by respondents. As part of the UIL received (see the UIL consultation) published alongside this report), parties suggested reporting templates covering fiduciary



management fees and performance. We are consulting on our provisional view to reject these. If we make a market investigation reference to the CMA, this is something which we would expect them to consider.

We agree with respondents and support measures to improve trustee skills and expertise. As referenced earlier, the TPR produces investment guidance or occupational pension schemes and has an online learning programme to help trustees meet the legal requirements for knowledge and understanding.

Consultation on whether to make a market investigation reference to the Competition and Markets Authority on Investment Consultancy Services

15.25 Alongside our interim report we made a provisional decision to make a market investigation reference to the CMA in relation to the provision of investment consultancy services.⁷⁰ We consider using this regulatory tool when we have reasonable grounds to suspect any feature or combination of features of a market or markets for the supply or acquisition of financial services distorts competition. In this case we considered those features were:

- A weak demand side:
 - trustees of pension schemes have limited or variable experience together with limited resources, resulting in a higher dependency on investment consultants
 - trustees are not able to assess the quality of advice provided by consultants
 - switching rates are low
- Relatively high levels of concentration and relatively stable market shares among investment consultants, which indicate that competition may not be working effectively in this sector.
- High barriers to entry and expansion. This particularly restricts smaller, newer consultants from developing their business outside of niche, specialist areas.
- Vertically integrated business models (where firms are offering both advisory and fiduciary management services) creating conflicts of interest.

15.26 We received responses from a diverse range of respondents on the market investigation reference including from investment consultants, asset managers, interest groups, trade bodies and think tanks. The majority agreed with our provisional decision to make a referral to the CMA, however many investment consultants did not consider there was a need for a market investigation reference. The three largest investment consultants submitted UIL designed to address these concerns. We have reached a provisional view to reject these proposals for the following reasons.

⁷⁰ Investment consultancy services' is defined in paragraphs 5.2-5.4 of the terms of reference in our published provisional decision to make a market investigation reference www.fca.org.uk/publication/market-studies/ms15-2-2-a-mir.pdf

- Without having carried out a full market study we are unable to confirm our understanding of the competition issues in this sector. A full investigation of the sector by the CMA would enable them to identify all the relevant issues and put appropriate remedies in place.
- In particular, the CMA would be able to fully investigate the most effective disclosures for trustees/investors ensuring the information provided was appropriate across the range of products and services provided by the sector.
- The UIL package only covers approximately 56% of the market, which leaves the possibility of competition issues for a large segment of the market unaddressed.⁷¹ In particular, some firms offering advisory and fiduciary management services would still face conflicts of interest.
- Finally, given the conflicts of interest we have raised with the vertically integrated business models in this market, we cannot reasonably be confident, at this stage, that structural remedies are not necessary.

15.27 We are publically consulting to seek views on these proposals before making our final decision. For further information please refer to the letter to the UIL parties published alongside this final report.

Consultation of whether to bring the provision of asset allocation advice and advice provided by employee benefit consultants within the FCA's regulatory perimeter

15.28 In addition to our provisional decision to make a market investigation reference, we considered recommending that the Treasury brings the provision of investment consultant and employee benefit consultant asset allocation advice within the regulatory perimeter.

15.29 The majority of respondents agreed that the regulatory perimeter should be extended to include, for example:

- employee benefit consultants advising employers who want to set up contract-based occupational schemes on choice of provider and how to set up their pension schemes, and then managing it on an on-going basis
- strategic asset allocation advice provided by investment consultants and manager research selection

15.30 The majority in favour of increased regulation considered asset allocation an important driver of outcomes. Several respondents also noted the key role that investment consultants play in trustee decision-making was an important reason to consider regulating them. It was also considered that regulation would provide a level playing field across the sector, as in other areas of investment advice. In addition, a trade body believed investment consultants should have individual accountability and likened this to our existing CF30 roles.⁷²

71 Page 142 of the interim report www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

72 These are Approved Person roles required for individuals undertaking various regulated advice activities.



- 15.31** Of the few respondents who were against an increase in regulation some felt that previous reviews of these services had considered the appropriate issues. Others considered the professional standards within this sector were sufficient. Specifically respondents raised the existing high standards for the industry through the Institute and Faculty of Actuaries Actuaries' Code and the professional bodies. Some of these respondents were also Designated Professional Bodies under the current regulatory regime.
- 15.32** Some respondents had concerns that additional regulation could result in unintended consequences, including higher costs and increased barriers to entry and that these factors could impact on outcomes for clients.
- 15.33** Finally, a few respondents highlighted that the FAMR was looking to reduce the scope of regulation and proposals to widen the regulatory perimeter to include advice on asset allocation may be inconsistent with the intention of this

Extending the regulatory perimeter to include institutional advice – our response

In the interim report we identified that asset allocation is likely to be a crucial determining factor in long term investment performance and is an important way in which consultants can add value to their clients. Bringing this within our regulatory scope would not only improve regulatory oversight of this activity, it would also mean we would be in a position to take forward any recommendations put forward by any potential CMA market investigation reference.

We are recommending that the Treasury consider, subject to the provisional market investigation reference, an extension of our regulatory perimeter to include asset allocation advice. If the Treasury made this legislation, we would consult on how to implement this in to our handbook and carry out a cost benefit analysis to facilitate a proportionate regime.

Appendix 1

Glossary of terms used in this document

Absolute return funds	These funds aim to deliver a positive return in any market condition, but returns are not guaranteed. Usually the target return is expressed with reference to a cash benchmark (e.g. LIBOR) over a specific time period.
Active management	The manager aims to achieve a specific result, such as beating the performance of a benchmark index, by actively making decisions when investing in particular markets, sectors or securities. When we refer to active funds in this document this includes all investment strategies which are not following a passive investment strategy.
Ad Valorem fee	A fee structured as a fixed percentage of the assessed value of the assets being managed. It means 'according to value'.
Adviser platforms	Online services used mainly by intermediaries to view and administer investments on behalf of advised retail customers.
Ancillary service providers	Third party firms which provide services to help operate a fund or support an investment mandate.
Asset allocation	Allocating different proportions of an investment portfolio to a mix of different asset classes (e.g. equities, fixed income, cash). These allocations are intended to help investors achieve their investment objectives in line with their risk tolerance and over a certain time period.
Asset class	A group of securities which share similar characteristics and are subject to similar laws and regulatory requirements. Asset classes include equities, fixed income and cash.
Barrier to entry	A specific feature of a market that gives incumbent firms advantages over potential competitors.
Benchmark	A standard against which the performance of an investment product can be compared. For example, a benchmark could be the performance of the market index, or the performance of a peer group of products.
Best buy lists	A list of funds which Direct-to-Consumer platforms offer as their view of the 'best' funds available to investors in a particular sector and/or asset class.
Bid-offer spread	The difference between the bid (the highest price a buyer is willing to pay) and offer (the lowest price the seller is willing to accept).
Box profits	In some funds there is a difference between the price to buy units in the fund and the price to sell them. This is used to cover the cost of buying or selling the underlying securities. When the asset manager can match up investors to buy and sell units they do not incur a cost of trading the underlying securities, but the manager can still keep the difference, which is called a (risk-free) box profit.
Bundle	Buying more than one product or service from the same provider and paying one combined, sometimes discounted, fee for the whole package.
Churn	Unnecessary trading which is largely undertaken to generate commissions or fees, rather than produce a return for the client.



Contract-based scheme	A pension scheme bought by an individual, often through their employer, and managed by a third party pension provider. It is owned entirely by the individual and the contract is between the individual and the pension provider.
Defined Benefit scheme	A trust-based pension scheme in which the benefits are defined in the scheme rules and accrue regardless of the contributions that are paid and the investment returns. The benefits are usually a proportion of the member's salary when they retired and are related to the length of their pensionable employment.
Defined Contribution scheme	A scheme in which a member's benefits depend on the value of their total pot. The pot, in turn, depends on the amount of contributions the member paid into it, and any investment returns net of charges.
Economies of scale	A cost advantage that occurs as output levels increase.
Execution quality	How well an asset manager trades on behalf of their investors, taking into account where and when they trade.
Fiduciary management	This is an industry term with no set definition. Usually taken to describe cases where a service provider advises clients on how to invest their assets and then makes investments on behalf of the client for all or some of their assets as well. These delegated responsibilities can include selecting asset manager and strategic asset allocation. This is sometimes also called implemented consulting.
Financial advisers	Those who offer personal investment advice to retail investors.
Fund of funds	A fund which holds a portfolio of other investment funds rather than investing directly in stocks, bonds or other securities.
Fund operator	This could be the Authorised Fund Manager, Authorised Corporate Director or the person appointed or responsible for managing of the property held for, or within, a scheme. For the full regulatory definition see the FCA Handbook.
Host Authorised Corporate Director	An independent third party (i.e. non-group entity) appointed to act as an Authorised Corporate Director for an Open-ended Investment Company (OEIC).
Implicit and explicit transaction cost	The cost to buy and sell securities. These costs could be a direct charge ('explicit' cost) or could be reflected in the price of the security ('implicit' cost).
Index tracker	See 'Passive'.
Institutional investor	An investing legal entity which pools money from various sources to make investments.
Investment Solutions	A combination of products and/or services delivered as part of one package to investors, often to achieve a pre-defined investment outcome.
Manager-of-manager	A type of multi-manager strategy which selects different investment managers to manage different portions or aspects of the overall portfolio.
Mandate	A list of restrictions or permissions from the investor about how assets can be invested.

Master trust	A single occupational trust-based pension scheme established by a trust agreement. This is set up to provide benefits to members from different employers (no individual employer group has a separate section with its' own trustees).
Model portfolio	A selection of investments designed by firms as 'off the shelf' solutions to meet different risk profiles and investment objectives.
Most Favoured Nation clause	A 'Most Favoured Nation' clause entitles a customer to obtain the most-favourable terms that a supplier offers to any other customer.
Multi-asset fund	A fund that includes several asset classes, for example bonds and equity, rather than just one asset class. This kind of fund is often created with the intention of adding diversification. They have also been known as balanced or diversified growth funds.
Multi-manager funds	An investment portfolio's assets are allocated among several fund managers.
Outliers	An observation point or result that is distant from other observations.
Net flow / into funds	Net flow of funds is the value of all cash flows into a fund minus all cash flows leaving it, measured over a specific time period.
Net performance	Investment return after fees.
Passive management	Strategies which seek to mimic the performance of an index using a systematic process to replicate it.
Pension freedoms	A package of reforms to the retirement market announced in the Budget 2014 and introduced in April 2015. These reforms give consumers greater freedom over how to generate a retirement income from their pension savings.
Platform	A service that gives investors access to a range of funds managed by different asset managers, typically online.
Pooled funds	Funds where money from different investors is pooled and managed together.
Prescribed Responsibility	Responsibilities that must be assigned to the individuals who hold Senior Management Functions.
Replicate the market	Where a portfolio is constructed either in full or using sampling techniques to generate returns equivalent to those of the market.
Retail investors	For the purpose of this document this includes all non-institutional investors.
Risk-adjusted net returns	A correction to the return (after fees) which reflects how much risk has been taken in order to produce that return.
Segregated mandate	A fund that is run exclusively for one (institutional) investor.
Stewardship	An asset managers' activities which work to improve the performance of underlying assets by acting on behalf of clients to, for example, manage emerging risks or take account of social impacts of business decisions.
Tiered pricing	Pricing that applies discounts and so reduces the cost per unit at stepped intervals as the volume bought increases.

Appendix 2

Abbreviations used in this paper

AFM	Authorised Fund Manager
AIF	Alternative Investment Fund
AMC	Annual Management Charge
ARF	Absolute Return Fund
AUM	Assets Under Management
bps	Basis points (equal to one hundredth of one percentage point)
CMA	Competition and Markets Authority
COBS	Conduct of Business Sourcebook
COLL	Collective Investment Schemes
CP	Consultation Paper
DB	Defined Benefit (pension)
DC	Defined Contribution (pension)
DWP	The Department for Work and Pensions
ESG	Environmental, Social and Governance
EU	European Union
FAMR	Financial Advice Market Review
FSMA	Financial Services and Markets Act
GIPS	Global Investment Performance Standards
IA	The Investment Association
IGC	Independent Governance Committee

IMA	Investment Management Agreement
IOSCO	International Organization of Securities Commissions
ISA	Individual Savings Account
KID	Key Investor Document
KIID	Key Investor Information Document
LDI	Liability Driven Investment
LGPS	The Local Government Pension Scheme
LIBOR	London Interbank Offered Rate
MFN	Most Favoured Nation Clause
MiFID	Markets in Financial Instruments Directive
MiFID II	Markets in Financial Instruments Directive II
NDA	Non-Disclosure Agreement
OCF	Ongoing Charges Figure
PRIIPs	Packaged Retail and Insurance-based Investment Products
RDR	Retail Distribution Review
ROCE	Return on Capital Employed
SM&CR	Senior Managers and Certification Regime
TPR	The Pensions Regulator
TTF	The Transparency Task Force
UCITS	Undertakings for Collective Investment Transferable Securities
UIL	Undertaking(s) in Lieu



We have developed this work in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

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