THE INVESTMENT ASSOCIATION

FCA Asset Management Market Study: Response to Interim Report

February 2017

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FOREWORD

Managing other people's money comes with a significant responsibility. That responsibility is increasing as millions of UK citizens are automatically enrolled into individual pension accounts, and will increase further as the Pension Freedoms provide greater choice and flexibility. Asset management is a critical part of the saving process. It is essential in providing both the capital allocation and the sound stewardship needed to generate long-term returns.

The UK today benefits from being the home of the world's second largest asset management centre (with only the USA being larger). Our industry is larger than those in Germany, France and Italy combined. In recent visits to America, China and Japan I have heard first hand that our industry has a hard-won reputation for expertise and innovation and we hope to see this bolstered in the post-Brexit world. This is an industry that manages £5.7trn and one which is now used by 75% of UK households.

In that context, the Market Study is a welcome opportunity for the FCA, industry and other stakeholders to look at the role of the asset management industry. For the industry to succeed in the years ahead, it needs the confidence of politicians, regulators and, most important of all, its customers. Our response to the Market Study is written in that spirit. The IA agrees that there are areas where the market can work better. Based on the Interim Report's proposed remedies, we set out a framework in which to deliver the best outcomes, transparently and in partnership with regulators.

The response also sets out a range of observations about the nature of asset management, in particular the role and performance of active managers. The Investment Association believes in an innovative market where customers should have access to a full range of products and services. Indexing is clearly an important and growing part of that range of options – indices best flourish where efficient capital allocation exists. Active managers are not alone in making those allocation decisions, but they are critical players in the process.

The value of asset management is increasingly being recognised and The Investment Association is pioneering initiatives that will benefit both our customers and the wider economy. Areas of focus include moving away from short-term reporting to a longer-term focus on investment by companies; the potential role of a municipal bond market; and how savers in DC schemes can invest on a more diversified basis. Our Productivity Action Plan brings together a number of work streams and we will be reporting on progress in the Spring. We will also soon be consulting on a ground-breaking Disclosure Code. Only by looking along the whole chain, from the customer to the underlying investment itself, can we get to the right place.

We look forward to working with the FCA and all other stakeholders to ensure that the industry is able to fulfil its responsibilities in a regulatory environment that balances challenge with dialogue and support for a world-class sector.

Chris Cummings, Chief Executive, The Investment Association

INTRODUCTION

1. The Investment Association (IA) welcomes the opportunity to respond to the Interim Report of the FCA Market Study and strongly supports the overall objective, namely to ensure that the industry serves its customer base in a competitive, clear, transparent, accountable and ultimately successful manner.

2. This response sets out detailed views on both the findings and potential remedies set out in the Interim Report. The remedies raise significant pre-existing themes in the UK and EU policy and regulatory debate, providing an opportunity to explore the competition analysis in the context of ongoing and forthcoming change. This links in turn to the importance of a broader debate – and settlement – as part of the Market Study process on the balance between three key sources of influence upon competitive dynamics:

    - Regulation and supervision
    - Market forces (including intermediaries such as distributors and advisers)
    - Firm and product level governance (including independent challenge).

3. The best consumer outcomes will be delivered in a market where the balance between these influences is measured and calibrated effectively. In broad terms, a competitive market is one in which proportionate regulation combines with other disciplines to provide all savers and investors with a wide choice of product offered by numerous different firms on a basis that can ultimately be judged by savers, investors and those advising them to provide value for money. Price clearly matters in value for money assessments, but asset managers are also selected and judged according to other important criteria relating to the specific service delivered.

A framework for competitive, value-focused delivery

4. The areas covered in the Interim Report remedies set out a clear customer-focused agenda that the investment management industry shares. The IA would like the industry and regulator to work together to deliver the following:

    a. **A charging structure that uses a single Ongoing Charges Figure to account for the fees taken for professional fund management services.**

    b. **Greater consistency in the expression of fund objectives and reporting of delivery against those objectives.**

    c. **A new Disclosure Code (well advanced already) for charges and transaction costs that covers not just the institutional market, but all substitutable UK long-term savings products and services.**

    d. **Enhanced fund governance processes across the product lifecycle, proportionately applied and subject to effective challenge. This means demonstrably robust mechanisms for the**

definition, consideration and reporting of how funds deliver in the best interests of clients to enable governance bodies, advisers and investors to better assess and compare value.

e. **A revised regulatory framework to facilitate delivery of good consumer outcomes in areas such as legacy switching and fund mergers so as to remove barriers to consumers both being offered and moving into the best value products.**

5. Such changes should have five key underlying objectives:

   a. To facilitate customer choice and access across the market, whether products and services are provided on an active or passive basis. Facilitating choice also requires that changes in the UK do not impede cross-border competition, effectively reducing the ability of UK savers to access overseas products and vice versa.

   b. To recognise and build on the direction of travel in existing and forthcoming regulation which is already transformative in key thematic areas covered in the Interim Report, notably MiFID II, PRIIPs, RDR and SMCR.

   c. To establish a framework that ensures the application of these different regulatory changes is both proportionate and joined up where there are common themes, avoiding overlapping and duplicative regulation.

   d. To foster an environment in which the active allocation of capital necessary for the good functioning of both markets and the underlying economy can take place effectively.

   e. To harness technological innovation in such a way as to facilitate improved efficiency, transparency, information flow and customer communications.

6. Intermediaries play a valuable and important role in connecting the asset management industry with its customers. We agree with the FCA's observation that the focus needs to be on both intermediaries and asset managers, and support the intention of the FCA to undertake further work on the retail chain. Consumer understanding and the decision-making processes that affect retail investor outcomes need to be considered in the context of different elements of value delivered through the chain and not merely by focusing on the manufacturing process.

Data and findings

7. While there are clear thematic continuities from a policy and supervisory perspective, further data and clarification is needed to support both the market analysis and the connection between the findings and the range of remedies under consideration. We are concerned that the evidence base used to justify the remedies is less clear than we would expect at this stage and we identify some significant areas where further analysis would be helpful.

8. Some of this clarity may be provided by the extensive ongoing work noted in the Interim Report, which we encourage the FCA to publish as soon as possible and certainly before the Final Report is released in order to facilitate industry and wider stakeholder comment. We analyse data and findings from the Interim Report in detail in Part Two and in Annex One. We would like to

establish a further dialogue between the industry and FCA on all of these points ahead of the Final Report.

9. Competitive dynamics at the manufacturing level should also be considered in the context of all long-term investment products, rather than narrowly focusing on open-ended investment funds and segregated mandates. Investment funds compete not just against each other, but against other forms of product: for example, investment trusts, unit-linked insurance products, or, in the case of multi-asset funds, model portfolios produced by discretionary portfolio managers.

10. To paragraph 6 above, as part of the additional work needed on the retail market, we would like to collaborate further with the regulator to establish a stronger evidence base on how best to deliver enhanced consumer disclosure as well as explore how this could link to investor education.

11. In the context of remedies we hope that the FCA will provide additional details on practical implementation and assessment. For example, it would be helpful to understand the timeframe over which different remedies would be implemented and how this interacts with the implementation of forthcoming regulation such as MiFID II and PRIIPs.

12. Finally, it would be useful to understand what steps the FCA intends to take to measure the effectiveness of any remedies that are implemented. For example, what data may need to be monitored over time and whether the FCA will commit to reviewing these remedies after a particular period.

Structure of the response

13. Our response is in seven parts:

- <u>Part One: Shape of the UK Asset Management Industry</u>. In pooling the savings of millions of individuals and households, the asset management industry plays a key role in channelling capital into the economy. As part of this, active management should be defined more broadly than stocks and securities selection, encompassing capital allocation, price formation, risk management and asset allocation. Asset managers also fulfil important oversight and stewardship functions on behalf of investors. These activities are all pre-requisites for well-functioning markets.

- <u>Part Two: Retail Market Competition, Price and Performance</u>. The Interim Report presents a number of key findings from the retail market relating to price trends, price clustering, outcomes, investor behaviour, and industry profitability. This Part considers these findings, commenting on the fact base as presented and, where relevant, providing additional evidence. Taken as a whole, our analysis suggests that further consideration should be given as to whether the findings are as consistent with weak price competition as the Interim Report asserts.

- <u>Part Three: Investment Fund Fee Structures</u>. Transparency of charges and costs across the long-term savings market is a pre-requisite for building consumer trust. This Part analyses the FCA's findings and proposed remedies, particularly given concerns about the incentives on managers to control different types of costs. We conclude that a single charge based on the OCF could provide a simpler proposition for customers to understand the cost of the professional service, alongside an estimate of the transaction costs needed to deliver a return for customers. We also put forward proposals on presentation, linking to the new IA Disclosure Code, which will deliver a comprehensive and consistent charge and cost accountability framework.

- Part Four: Investment Fund Disclosure and Objectives. The Interim Report expresses a range of concerns about how asset managers communicate their objectives and outcomes to investors, and sets out preliminary views about the way forward. The IA agrees that clarity of objectives and accountability for outcomes is extremely important and looks forward to dialogue with the FCA about how to address the issues identified. One particular area of focus should be the scope for greater consistency of language and terminology. We link the themes raised here to the discussion on 'Value for Money' whereby any enhanced consideration or reporting requirements on value should necessarily include consideration of delivery in the context of fund objectives.

- Part Five: Investment Fund Governance. The IA supports the highest standards of fund governance. As a way to ensure that customers can access products that they judge to be good value for money, we set out how greater clarity of objectives and of fees and costs can be brought together with new product governance requirements in the context of the duty of care to unitholders. We also consider how the exercise of that duty can be best subjected to effective challenge. The answer is likely to lie with a proportionate approach, drawing on European fund governance models, rather than importing models from other parts of industry, domestically or internationally.

- Part Six: Regulatory Framework. A range of issues arise in the Interim Report where the IA considers that regulatory change may be particularly necessary, focusing on barriers to switching (whether from legacy share classes or other situations in which fund managers might wish to close or merge share classes). We would like to work with the FCA to ensure that fund managers are more easily able to move investors to better value share classes and we argue for a sunset clause on trail commission to UK financial advisers. There are several areas in which enhanced regulatory processes could facilitate fund mergers/closures, again to the benefit of investors.

- Part Seven: Institutional Market. The Interim Report covers a broad range of areas regarding the institutional market. While solutions such as pooling may be effective in some areas, a number of core principles are clearly fundamental in helping to facilitate good outcomes. We identify the importance of enhanced transparency from the industry and enhanced investment governance at the client level. Improvements in these areas, alongside changes to the way in which investment consultants operate, notably bringing their activity into the FCA's regulatory perimeter, will help the institutional market operate more effectively.

14. We also provide five Annexes:

- Annex One: Technical analysis
- Annex Two: Box management
- Annex Three: Fund governance structures
- Annex Four: Key stages in the product development life cycle
- Annex Five: IA Disclosure Code templates

PART ONE: SHAPE OF THE UK ASSET MANAGEMENT INDUSTRY

Summary

Section 1 – Economic function of industry

15. In pooling the savings of millions of individuals and households, the asset management industry plays a key role in channelling capital into the economy. As part of this, active management should be defined more broadly than stocks and securities selection, encompassing capital allocation, price formation, risk management and asset allocation. Asset managers also fulfil important oversight and stewardship functions. These activities are all pre-requisites for well-functioning markets.

Section 2 – International Dimension

16. The highly international nature of the industry has a particular relevance for the Market Study in that competition in the UK does not uniquely take place between domestically-domiciled funds, but between funds from across Europe. Another important aspect of this European dimension is the significance of EU regulation in areas covered by the Market Study, notably disclosure and product governance. While Brexit may see an evolution over time, EU regulation remains paramount in the near term. UK-based asset management firms also compete in markets across the world.

Section 3 – Routes to market and types of investor

17. Both the UK retail and institutional markets are highly intermediated by advisers and platforms. There is also a wide variety of different kinds of investor using the UK retail market. The combination of intermediation and different investors means that solutions in areas such as disclosure and the drivers of buying/selling behaviour need consideration in this broader context.

Section 4 – Product diversity and innovation

18. Both the UK retail and institutional markets are characterised by evolving product sets and clear evidence of innovation in meeting changing investor needs. From a major concentration on UK equity investing two decades ago, all parts of the market are more diversified, with a particular rise in the role of 'solution' products alongside single asset class specialist funds or mandates. Sales patterns in recent years have reflected a wide range of investor demands, including income and absolute return, which also illustrate selection on a range of criteria other than price alone.

Section 5 – Diverse eco-system

19. The UK asset management industry is also characterised by a very diverse group of firms, with little evidence of any significant degree of concentration. This is seen not only in the market share data, but in the changing composition of the larger players and funds within this.

1. Economic function of industry

20. The asset management industry[1] exists to pool together the savings of millions of individuals and households and invest them productively in the economy, domestically and internationally. In doing so, firms provide expertise, access to markets and regions and economies of scale that are otherwise unavailable to the vast majority of individual savers. Some of this pooling takes place directly through the retail fund market, but much more occurs through institutions such as insurers and pension schemes who use the services of asset managers.[2]

21. Increasingly, the decline in traditional risk-sharing mechanisms such as defined benefit pensions or with-profits schemes mean that long-term saving is taking place in individual accounts with the investment risk ultimately borne by savers. This trend, seen internationally as well, imposes a significant responsibility on investment managers and others in the delivery chain, notably advisers and distributors.

22. The Market Study focuses rightly on services to customers, whether in the retail or institutional market. The duty to customers is central to asset management, and we discuss this in more detail later in the response. As the FCA Interim Report acknowledges, there is also an important link between asset management products and services and growth in the wider economy. This fundamental point is sometimes overlooked in public debate, particularly given the frequent focus on active versus passive management as simply a relative performance contest, particularly in equity markets.

23. Asset management should be defined more broadly:

    - UK asset managers currently provide tens of billions of pounds a year in finance for UK corporates in equity and debt issuance, responsible for about 60% of capital market funding.[3] At the same time, they support a variety of infrastructure needs, including social housing. Active allocation of capital – i.e. a discretionary decision to invest/disinvest – lies at the heart of this process, alongside non-discretionary allocation through indexing. With ownership comes responsibility, notably in corporate engagement and stewardship.

    - Secondary market activity by asset managers, alongside other market participants, supports essential market functions, notably reliable price formation which is the cornerstone of fair markets. This price formation in turn facilitates the operation of indices, which reflect the price movements of a given basket of stocks and securities. In this regard, active and passive management are closely interconnected, with index tracking dependent upon the decisions of all other investors (a range of individuals, institutions and professional asset managers).

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[1] Throughout this response, we make references to 'asset management' and 'fund management'. 'Asset management' refers to all products and services whereas 'fund management' refers to authorised investment funds specifically.

[2] The benefits of this pooling has been quantified by OXERA in their 2016 report, *The contribution of asset management to the UK economy*. OXERA showed that for a £10,000 investment, it can cost seven times more to invest directly in the market than via an investment fund.

[3] OXERA (2016), p.14.

Asset managers as a group tend to hold stocks and securities over much longer periods than the market average holding period, with independent research estimating this at six years for UK equities.[4] This is also longer than the typical holding period of units by retail investors (see paragraph 92).

- Expertise in risk management and asset allocation allow managers to provide clients with products and services that cater to a variety of different needs. Asset allocation products may well use indexing to access underlying markets, but the decisions as to how to allocate will usually be made as an active decision.

24. This leads in turn to a number of observations about the wider context of the Market Study:

- There is an opportunity to broaden the debate about the role and delivery of the asset management industry to include the importance of capital allocation and activities such as stewardship and engagement. As regulators and industry reflect on the broader challenge of ensuring confidence in the long-term savings process, wider recognition of these activities may help to foster a better understanding of the benefits of investment at both an individual and collective level.

- Fund managers are both observers and actors in the same process of price formation. As the FCA acknowledges, average performance across all market participants will be a zero sum game. Evidence presented in the Interim Report, however, indicates positive net returns in some parts of the market, notably active equity funds. This suggests UK fund managers as a group have outperformed other market participants, particularly when measured on a money-weighted basis, a finding reinforced by past IA analysis.

- Measurement – and expectation – of active performance can only be properly judged against delivery net of fund management costs. While comparison of performance based on total cost of ownership (fund manager and distributor/adviser) is a critical metric for overall consumer outcomes, it is a highly misleading metric for measurement of delivery by fund managers in the context of a competition study focusing narrowly on fund management. This is particularly the case given the unbundling that has occurred under RDR (see discussion in Part Two).

- Performance and cost of an active or index fund needs to be considered in the context of the specific services provided. Not all funds, particularly outcome-focused and allocation funds, will have access to a clear external benchmark or will wish to be constrained by a benchmark. Furthermore, outcome and allocation funds compete not just with other similar funds but with others in the investment chain providing a similar service (see Annex One).

2. International dimension

25. The UK asset management industry is highly international and this can be observed in five key respects:

[4] OXERA (2016), pp.16-17.

- Fund markets. Investment funds are both exported to and imported from other European jurisdictions as part of the single market in financial services. Although overseas-domiciled funds are a comparatively small part of the domestic retail market, they are heavily invested in by institutional investors, notably in the money markets sector.

- Client location. Overseas clients investing through both investment funds and segregated mandates account for about 40% of total assets under management in the United Kingdom. This contributes significantly to annual export earnings, accounting for 6% of net services exports on average over the past decade. While European clients account for just over half of overseas client assets, exports to the rest of the world are an important component of UK-based asset management activity.

- Investment location. The UK asset management industry invests extensively overseas on behalf of both domestic and overseas clients. From the UK, two thirds of equity investment is in overseas markets, and just over a third of fixed income investment.

- Parent headquarters. Some 60% of assets under managements in the United Kingdom are now managed by groups whose parent group headquarters are overseas.

- Source of regulation. Key regulation, affecting both retail and institutional asset management products and services, as well as the capital markets in which they operate, is determined by a combination of domestic and European legislation and, increasingly, within a wider global regulatory framework.

26. This is relevant for the competition study in several important respects:

- Domestic regulation can act as a source of good practice to be exported internationally, enhancing the industry's reputation. It is also possible for the reverse to be true, with domestic regulation that is out of line with international regulation adversely affecting competition within the UK market and the competitiveness of UK asset managers overseas. As we explore in Part Three, some of the fee structure remedies proposed by the FCA would put the UK domestic fund market out of line with international, particularly European, norms, leading to a distortion of competition in the UK market if overseas domiciled funds present different information on fees. At the same time, competition in overseas markets would also be distorted as the export capability of the UK industry would be damaged. This may feedback into diminished product and services innovation in the UK market, as well as damaging export earnings. While we recognise that damaging export earnings is not a primary consideration under current FCA priorities, any damage to innovation is of considerable consequence for competition dynamics.

- Wide-reaching changes in European disclosure and capital markets legislation lie ahead under PRIIPs and MiFID II. In addition to new product governance requirements under MiFID II, there are particular ramifications of both PRIIPs and MiFID II for consumer disclosure, both pre-sale and post-sale, which will have a dramatic impact on the way in which client cost accountability operates. Most notably, all transaction costs, including implicit costs, will be disclosed, and all costs through the value chain (including fund management, distribution and advice) will be disclosed by distributors using pounds and pence figure. As we discuss further in Part Three, there are, however, major flaws in the way in which this presentation is currently being constructed. While an industry Code will ensure that all data is available, the way in which information is presented should be the subject of further testing and dialogue between industry, regulators and consumer representatives.

3. Routes to market and types of investor

27. The majority of the retail asset management market depends upon some form of adviser or gatekeeper, something which has profound implications for the analysis of supply and demand side interaction.

28. The UK retail funds market, unlike other European markets, continues to be characterised by a heavy focus on IFA distribution, and comparatively low levels of bancassurance activity, a feature even more in evidence post-RDR. The Interim Report quotes IA data suggesting that close to 80% of retail sales by volume continue to be advised sales.[5] Direct distribution remains much less important, representing only 10% of gross retail sales in 2015 (and 8% in 2016 – see Annex One). Despite expectations in some quarters that this may gradually change in the context of evolving technology, there is no significant evidence that this is the case. Rather, technology appears to be facilitating the emergence of new intermediaries offering both access to funds and portfolio construction services.

29. Over the past decade, both advised and non-advised consumers have increasingly used the services of different kinds of platform. Some platforms provide essentially a utility service, others offer greater added value, including best buy lists, advice and fund management. There is also extensive provision of third party fund ratings services, which may inform both advised and non-advised purchases. We note that the impact of best buy lists and third party fund ratings are currently the subject of additional analysis by the FCA ahead of the Final Report and we will respond further to the findings as they emerge.[6]

30. Annex One provides further detail on how the retail market operates, drawing particular attention to the need to acknowledge that there are different kinds of investor and diverse routes to purchasing funds. 'One size fits all' approaches in areas such as disclosure are therefore difficult to implement. It is also the case that some of the issues around switching identified in the Interim Report are connected to challenges in the distribution process with respect to how and when investors move from more expensive and/or poorly performing share classes or funds. These challenges are quite broad and require further exploration in the context of the Market Study. For example, how investors move from pre-RDR share classes is partly a legal/regulatory question (see Part Six). How investors move from poorly performing funds links to the wider debate about the role of advice and guidance through the delivery chain.

31. The institutional market, including the DC workplace pensions market, which is in some ways a hybrid between institutional and retail, is also highly intermediated. The role of investment

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[5] Para 5.5, p.74.

[6] Para 4.126, p.72

advisers has been particularly important in the light of the 1995 Pensions Act, which was designed to ensure much more robust pension governance processes post-Maxwell. We comment in more detail on the role of consultants in Part Seven.

32. It is also important to emphasise that both retail and institutional clients have access to a diverse range of investment delivery vehicles. We would suggest that competitive dynamics at the manufacturing level should be considered in the context of all long-term investment products, rather than narrowly focusing on open-ended investment funds and segregated mandates. Investment funds compete not just against each other, but against other forms of product: for example, investment trusts, unit-linked insurance products, or, in the case of multi-asset funds, model portfolios produced by discretionary portfolio managers.

4. Product diversity and innovation

33. Savers and investors are able to access a wide range of fund products at appropriate points in the market cycle without signs of market dominance by individual funds or firms. This range of choice can be seen in multiple ways, from active and passive components giving exposure to specific markets, to multi-asset funds focused on more specific outcomes.

34. The Interim Report refers to a market where products are marketed typically as either actively-managed strategies or passively-managed strategies.[7] This holds true within individual asset classes, notably equities where indexing is most widespread. However, as the Interim Report notes, the trend in recent years has been towards greater manufacture by asset managers of multi-asset, absolute return funds and other more solution-focused products. These are, by definition, active in terms of strategy construction, although some elements within the strategy may be delivered by passive components.

35. Competition in this market therefore takes place on a basis in which price is important, but not necessarily the only factor to be considered. This observation is consistent with consumer research, including that carried out by the FCA which showed that charges ranked similarly to factors such as firm reputation (brand), past performance and likely return.[8] This would be expected for a product set where past performance incorporates the price charged rather than being separated from it. We return to the issue of past performance in Part Four of this response, and note FCA findings in the Interim Report that track record can be indicative of propensity to deliver, notwithstanding the unpredictability of future market returns.

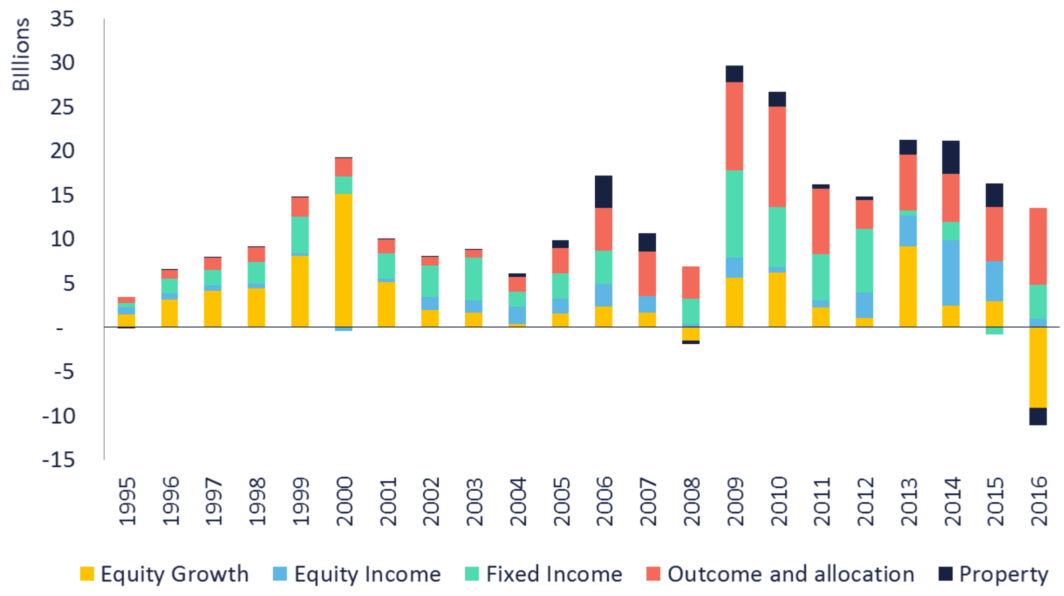
36. While the Interim Report hints at a degree of expectation of greater innovation, we would argue that comparing the choice set available across the market to the underlying market instruments available and regions accessible globally suggests that the industry has undergone a healthy evolution away from a more equity focused culture during the 1990s towards a very diverse product set at the level of both components and solutions.

37. Exhibit 1 illustrates trends in net retail sales over the past 20 years. Demand for outcome and allocation funds has been consistently strong since the 2008 financial crisis. Equity growth seems

[7] Para 3.31, p.38.
[8] See in particular FCA Annex 3, Figure 15.

to have undergone a significant change from the 1990s with weak investor demand since the dot com bubble in the early 2000s. Fixed income funds were particularly popular for the first couple of years following the 2008 crisis. Taken together, these trends and changes demonstrate that the demand for asset classes in the retail market is not static. It varies, in some cases strongly, according to many factors, not least, changes in the wider macroeconomic environment. The fund management industry both offers and develops the choice to meet investor demand.

Exhibit 1: Net retail sales by different asset class (1996-2016)



(Source: IA fund statistics)

38. This observation of changing product demand and changing supply-side dynamics is mirrored in the institutional market, which has also seen a strong move away from a more equity (particularly domestic equity) focused pattern of investment twenty years ago. The drivers of this shift are different in the retail and institutional markets, with accounting and regulatory change providing a significant impetus to pension scheme de-risking. As the Interim Report notes, there has been a particular innovation in the institutional market in recent years in the form of Liability Driven Investment (LDI) strategies, aimed at helping schemes better manage the uncertainties associated with future cash flows. There is also significant evolution in the area of Environment, Social and Governance (ESG) investing. We would expect further progress in this area in the context of the recent creation by Government of an Advisory Group to look at ways to make socially themed investments more easily available.

39. The trends seen in both the retail and institutional market are consistent with the kind of innovation that would be expected in a competitive market in response to changing client needs and market conditions: i.e. evolutionary rather than revolutionary. In the context of the Pension Freedoms, cited as an emerging driver of change in the Interim Report, we would agree that this is an area where there is likely to be further development, again on an evolutionary basis. Fund managers and the insurance industry already provide the key components to meet savers' needs (income generation strategies and longevity protection), but there is likely to be more thought

given to how income and protection can be combined in the context of Pension Freedoms, longer working lives and increasing longevity more broadly.

5. Diverse eco-system

40. Asset management is characterised by a particularly diverse eco-system in terms of firm size as well as products and services offered. Concentration, measured both at fund and firm level, is low, with the Herfindahl-Hirschman index (HHI) for firms being at 505 in 2015 and averaging 421 over the last decade.[9]

41. This low concentration is acknowledged by the FCA but with the caveat that *"a large number of competitors does not necessarily mean there is effective competition"* which is then described as follows: *"firms have sufficient incentives to identify and satisfy clients' demands as efficiently as possible and constantly seek to win the business of clients who use rivals' services"*.[10]

42. We agree that HHI cannot be taken in isolation and present additional evidence in this regard. For example, although the combined market share of the top 10 firms by retail funds under management was 47% in 2015 and has varied little as a proportion of total funds under management in the last twenty years, the composition and ordering of the top ten firms has changed significantly. None of the top three firms in 2015 was in the top ten in 2010 and only one was amongst the top ten in 2005.

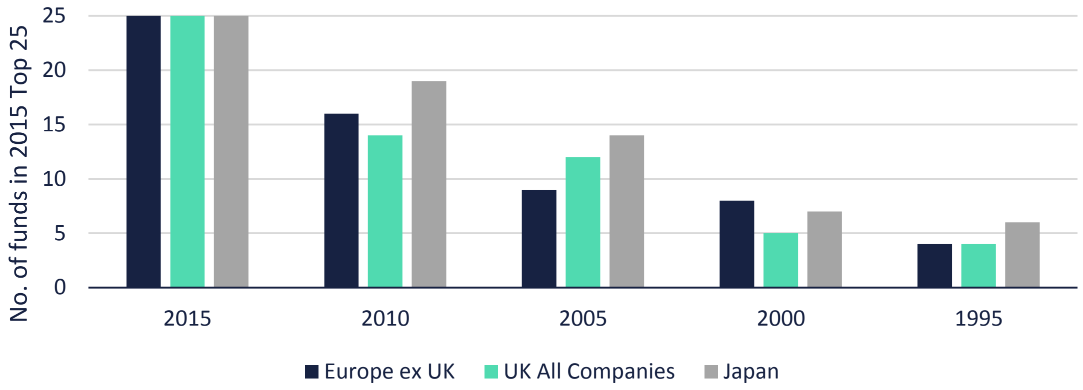
43. This is part of a longer trend that is also evident if one considers concentration (or lack thereof) at an asset class level. The market share of the top ten equity funds has remained broadly stable in the last 20 years (almost 20%) but the composition of this has changed. Moreover, the top ten fixed income funds accounted for 28% of gross sales in 2015 compared to 61% in 1996. Similarly, the market share of the top ten mixed-asset funds fell from 58% of gross sales in 1996 to 26% in 2015.

44. As a specific example, we have looked at the competition amongst the top 25 funds in three sectors: UK All Companies as the largest sector, Europe excluding UK that is at around the 75th percentile in terms of size and Japan that is at the median. Smaller sectors were excluded on the basis that they have a relatively small number of funds. Looking backwards from 2015 we see that the composition of the top 25 largest funds across the three sectors changes significantly over time. For example, in the Europe ex-UK sector only nine of the largest 25 funds in 2015 were in the top 25 in 2005 – see Exhibit 2.

45. There are of course many reasons why fund assets may change, e.g. manager or firm success, market cyclicality and investor needs to name but a few. As in other industries, success breeds imitation, therefore a fund's success may be short lived.

[9] The Investment Association, Asset Management in the UK 2015-2016.
[10] Para 3.15, p.33.

Exhibit 2: Continuity of top 25 funds over time



(Source: IA fund statistics)

PART TWO: RETAIL MARKET COMPETITION, PRICE AND PERFORMANCE

Summary

46. The Interim Report presents a number of key findings from the retail market relating to price trends, price clustering, outcomes, investor behaviour, and industry profitability. This Part considers these findings, commenting on the fact base as presented and, where relevant, providing additional evidence. Taken as a whole, our analysis suggests that further consideration should be given as to whether the findings are as consistent with weak price competition as the Interim Report asserts.

Section 1 – RDR and the evolution of the retail market

47. The Retail Distribution Review has prompted one of the most significant structural changes the UK retail savings market has ever seen, but is not widely referenced in the Interim Report. The RDR has been positive in key respects: driving up standards of advice, stimulating increased price competition among investment funds and providing greater transparency of cost. It also has significant implications for performance and price measurement given the introduction of unbundled share classes. Looking ahead, there are significant opportunities to build on RDR momentum.

Section 2 – Price dynamics

48. FCA and IA analysis points to falls in headline fees in both the active and passive markets post-RDR. On an unbundled basis, our analysis finds the price of active funds fell by 7bps to 0.92% from 2013 to 2015. The trend implications of this should be taken into account in competition analysis.

49. The Interim Report recognises that clustering can be indicative of positive patterns of competition, but we question why observed clustering in part of the active market is a negative factor, while price dispersion in the passive market is also seen as a negative factor.

Section 3 – Retail investor behaviour

50. The headline presentation of the Interim Report emphasises that 49% of non-advised investors were not aware that they were paying fund charges on their most recent product. In contrast, 77% confirmed that they looked at fund charges at the point of sale. There is therefore clear price awareness, but also possibly some confusion about the nature of different charges through the delivery chain.

51. Investors are often using both passive and active funds within portfolios, and the choice set is widening further as the ETF market develops. Sharper falls in the price of passive funds therefore reinforce the competitive dynamic across the market with greater choice overall.

52. A competitive financial services market is partly characterised by ease of switching. IA data suggests that fund holding periods have been falling in recent years, consistent with low barriers to switching.

Section 4 – Fund manager delivery

53. Judging fund manager performance on the basis of total cost of ownership (including costs of investment, advice and distribution) does not provide a way to assess investment delivery specifically. Even on this basis, active equity funds outperform their benchmarks, challenging the premise that on average a typical active and typical passive fund will produce the same outcome gross (or even net) of fees. Using post-RDR unbundled share classes, the empirical evidence is more clear-cut. Active equity funds outperform on both a simple average and a weighted average basis.

54. Funds should clearly state what they are setting out to achieve for a given fee, and metrics can play a role in guiding consumers alongside clear and consistent narrative. Tracking error can be a useful tool, but high tracking error is not indicative of high outcomes just as low tracking error is not the same as no likelihood to outperform. Part Four of our response sets out how the industry would like to work further with regulators on an appropriate disclosure regime.

Section 5 – Industry profitability

55. The competition analysis makes a strong connection between price in the retail market and overall profitability, measured both in terms of operating margin and return on capital. We observe significant variation in margin both between firms and over time. We also observe that industry return on capital can be much closer to the FCA's cost of capital range under certain reasonable assumptions that should be considered in the Interim Report's analysis.

Conclusions and further work

56. Taken together, the points above on price trends, investors' behaviour, manager delivery and profitability are not consistent with a retail market where there is a lack of price competition, particularly taking into account other factors such as innovation and low concentration, outlined in Part One. We suggest areas where more work might be undertaken to better understand the dynamics of demand in the retail market.

1. RDR and the evolution of the retail market

57. A number of key findings were presented in the Interim Report relating to price and outcomes in the retail market but the most important factor providing the context for both was little discussed. RDR, broadly supported by the fund management industry, is bringing about a transformation of the retail market. It is driving up standards in financial advice, affecting patterns of competition in the retail funds market and providing greater transparency of cost through the value chain. In our view, the success of RDR, and the emerging trends with respect to pricing, suggest both that the FCA is achieving its objectives and that the ongoing effect of the RDR should be more clearly acknowledged in the Interim Report. There are also emerging challenges, particularly around access to advice, which have implications for consumer behaviour. We consider these to be salient for the competition study.

58. The evolution of the market from a competition perspective over the past decade has been heavily coloured by the anticipation and realisation of the RDR. The structural change in fund pricing is of primary importance for examining price trends and assessing performance, as well as investigating future patterns of competition within the asset management industry. We explore the presentation of data in more detail in Annex One, and highlight below two key points:

    - Prior to the introduction of the RDR, measurement of fund 'performance' against a benchmark in the retail market was difficult at an investment management cost level due to the bundling of distribution and advice costs (in stark contrast to the institutional market). Consequently, what was measured as performance in the UK retail market using a bundled share class was the return against the benchmark relative to the 'total cost of ownership' covering asset management as well as the costs of advice and distribution. We would suggest this has never been a credible basis for assessing the investment value added by fund managers, but has served as a useful measure of the overall return to investors provided by the retail value chain as a whole. As we discuss further below, even on the return measure that is net of the total cost of ownership, both IA and FCA analysis suggest there has been robust performance by active managers.

    - An analysis of price trends over the last ten years is inevitably complicated by the structural shift that began in anticipation of the RDR introduction at the end of 2012 and was phased such that the full impact is still working through, with the last significant deadline (sunset clause on payments to platforms for existing unbundled business – but not for IFAs) passing in April 2016. Given that the market was largely functioning on a 'cost of ownership' basis including advice and distribution prior to 2012, there was an expectation that more visible investment charges (i.e. clean OCF) would have an impact on competitive dynamics in both active and passive parts of the market post-2012. This was already indicated in the initial FSA RDR discussion paper in 2007, which pointed to the aim of developing a regulatory framework which *"enables future innovation and competition where these deliver clear consumer benefits"*.[11]

[11] FSA, *A Review of Retail Distribution,* 07/1, June 2007, p.15.

59. The FCA's own analysis of the initial impact of RDR, carried out by Europe Economics, indicated that this was indeed what was happening. Europe Economics noted that:

"Generally, there appears to be increased competitive pressure on providers. The evidence on the change of product mix suggests that, with the removal of provider commission, advisers are exercising price pressure on providers. The removal of product bias appears to have contributed to a change in the products sold…

Likewise, the growth of platforms has also led to greater pressure on providers. Due to their scale, platforms typically have greater bargaining power. The competitive pressure exerted by platforms on providers is also expected to increase as platform rules banning commissions and rebates bed down. The growth in platforms and the recent decline in direct sales also suggest an increasing ability of platforms to negotiate lower product costs. In addition, our fieldwork indicates a levelling of the playing field between providers, as advisers search for the cheapest products rather than highest commissions or the most well-known providers. Some providers from this fieldwork have noted an increase in price pressure (e.g. in the form of more protracted negotiations)."[12]

60. This suggests that there is already additional price pressure on headline charges exercised by intermediaries. Additionally, given the amount of intermediation in the retail market, this has also brought about discounting of prices offered through some intermediaries. Therefore, many of the prices that retail investors actually pay will not necessarily be reflected in an analysis focusing only on headline charges.

61. The difference between factory gate price for a fund and the effective price via distributors should be explored in further analysis. Although the level of discounts secured by platforms is discussed (the FCA find this can be up to 38 basis points)[13], it is not clear to what extent this has been taken into account in the analysis looking at pricing trends[14] or altogether in the wider context of price competition in the market.

62. Furthermore, FCA behavioural analysis has a heavy reliance on a consumer survey of unadvised investors, many of whom were not directly investing in funds, but in pensions and ISAs. While aspects of the findings may mirror wider views, this should be tested further and the survey should not necessarily be seen as representative of the wider retail investor base, the majority of which is advised.

63. Overall, given how fundamentally RDR has changed pricing in the retail market, any conclusions on price competition need to account more for the structural shift from bundled to clean prices as well as the outcomes of the competitive pressure exercised by intermediaries that result in a different set of prices that retail investors experience rather than focus on headline fees only.

[12] Europe Economics, *Retail Distribution Review: Post Implementation Review*, December 2014, pp.100-101.

[13] See para 5.10, p.76.

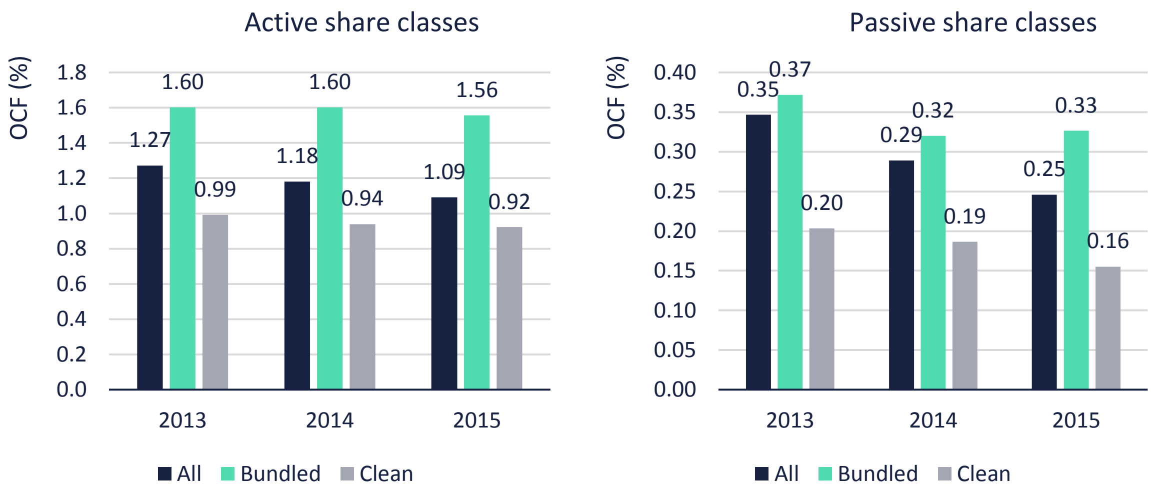
[14] See paras 6.71-6.77, pp.111-114.

2. Price dynamics

Price trends post-RDR

64. Although RDR is still fairly recent and its effect on competition dynamics has not fully played out yet, we are already seeing some changes even if we focus only on headline fees (i.e. excluding the effect of discounting discussed above). IA analysis points to falls in ongoing charges figures in both the active and passive markets post-RDR, something also seen in the FCA figures. Looking across the entire investment fund market, the asset-weighted average OCF for active funds fell from 1.27% to 1.09% between 2013 and 2015 and that for passive funds fell from 0.35% to 0.25% - see Exhibit 3.

Exhibit 3: Asset-weighted average OCF across active and passive share classes (2013-2015)



(Source: IA analysis based on Morningstar and Financial Express data)

65. Considering only the new primary (clean) share classes, IA analysis finds the price of active funds fell by 7 bps to 0.92% in three years. Falling prices among active funds are not only due to a movement towards unbundled share classes but also reflect a movement towards cheaper share classes within the unbundled segment. The asset-weighted average charge for active funds is both declining and lower than the simple average (which has remained close to 0.94%) indicating that clean share classes with lower OCF attract higher flows.

66. Within the new primary share classes in the UK All Companies sector – by far the largest sector in the retail market – the asset-weighted average OCF for active funds fell from 0.90% to 0.86% while the simple average has remained fairly stable around 0.95%, indicating again that more assets are invested in cheaper share classes within unbundled share classes (see full analysis in Annex One).

67. IA analysis further suggests that prices for active funds are both at different levels and have different dynamics across different sectors of the market. For example, looking at the asset-weighted average prices of the new primary share classes of active funds across other large sectors in the retail market, a UK equity income fund costs about 0.86%, while a North America equity fund costs 0.90%, and a Global equity fund 0.98%. Fixed income funds are, as expected,

cheaper than equity funds with the average Corporate Bond fund OCF at 0.65% whereas Strategic Bond funds cost on average 0.77%. Multi-asset funds cost on average over 1%.

68. Overall, IA data shows a slightly stronger decline for active funds (7 bps over three years) than that presented in the Interim Report on the long-term trend in Figure 6.14. Although three years is not long enough to predict with certainty the post-RDR trends that will eventually emerge, the direction of travel is not compatible, in our view, with a finding of weak price competition. This is particularly the case given that some aspects of RDR only took effect from April 2016 (i.e. after the period analysed by both the FCA and the IA), and greater pricing pressure is expected over time.

69. Furthermore, it is not clear from the FCA analysis why a similar scale of change in passive fees should be expected in active fees in order to conclude that there is competitive pressure for both, given the very different nature of the service offered, differences in cost base and the more readily available scale economies for passive funds.

70. Price would generally be expected to be a relatively more important factor for passive than active funds, given that a decision to track an index would then likely lead to a significant focus on how to do so in the most cost-effective manner.[15] There is a very high degree of homogeneity between many passive funds within a given sector as the investment strategy is the same, i.e. to track an index in that market. This is in contrast to active funds that may follow an income or a growth strategy, invest in value stocks, go for a concentrated portfolio in e.g. the oil and gas sector etc. so that price is not the only characteristic to be compared even if all the funds had the common objective to outperform an index (which is not necessarily the case).

Price clustering

71. Beyond trends in OCF, the FCA notes the distribution of AMC for equity funds and observes clustering for share classes with assets more than approximately £200m.[16] This appears to be one of the key factors in the FCA's conclusion that there is weak price competition in some areas of the market.

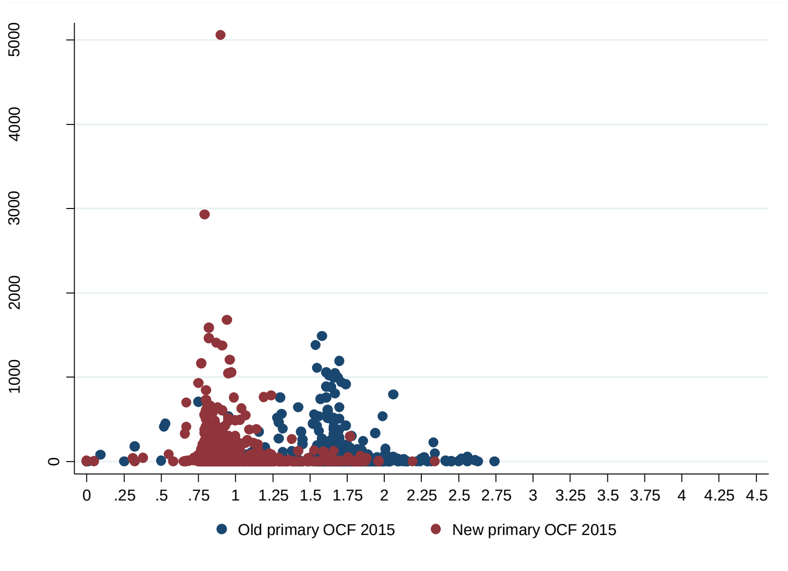
72. Our analysis of post-RDR clean share classes also points to a degree of concentration in price ranges, with 62% of the new primary OCF observations being between 0.75% and 1% – see Exhibit 4. This percentage increases for narrower categories, for example it is at 72% for UK All Companies Sector, which is to be expected with more similar products. However, not all share classes are priced at the same level (see fuller discussion in Annex One). There may be valid reasons for a degree of price dispersion for both active and passive funds. Even within the same sector, e.g. UK All Companies, where funds are similar in terms of geographic and asset class exposure, there may still be differences in terms of investment process. More generally, across

[15] There could still be other factors that investors may consider in their choice such as the overall service provided, communication, etc.

[16] Para 6.73, p.112. Figure 6.15 appears to indicate clustering from £200m and above and not £100m as is suggested in the Interim Report.

the market, firms may seek to distinguish themselves on a wider range of factors such as approach to stewardship, service and investor communications etc.

Exhibit 4: Distribution of OCF against funds under management for old (bundled) and new (clean) primary active equity share classes



(Source: IA analysis based on Morningstar and Financial Express data)

73. There are two issues that need to be carefully considered here:

- First, it is not clear why a degree of price clustering should be indicative of lack of competition. A competitive market would typically be characterised by similar prices for similar products, particularly if the underlying costs are similar too. The observation that *"clustering becomes more apparent when examining narrower investment categories"*[17] is consistent with the 'similar product-similar price' characteristic of perfect competition. This line of thought seems to be reflected in FCA's (negative) observations about the dispersion in the prices of passive funds observed in Figures 6.12 and 6.13.[18] As such we would like to understand better why price clustering is interpreted as a sign of lack of competition in one product set, while dispersion is seen as a problem in another.

- There is an inherent complication by looking at the AMC rather than the OCF (as Figures 1.5 and 6.15 do) when trying to determine the extent to which there is price competition. Although it is reasonable to expect that variations in the AMC will be reflected in the OCF, AMC and OCF indicate different things and there is a question as to whether retail investors (and intermediaries) consider the AMC or the OCF in their decision making processes. The UCITS regulation requires that all frontline documentation presents the OCF. Overall, there could be a misalignment between the assumption that asset managers should compete on the AMC and a retail market focusing on the OCF. At the same time, it may well be that asset managers compete on OCF in terms of both the management fee and how well they control other costs so that they offer an overall competitive price to investors. There are broader

[17] Para 6.72, p.112.

[18] Paras 6.58-6.59, pp.108.

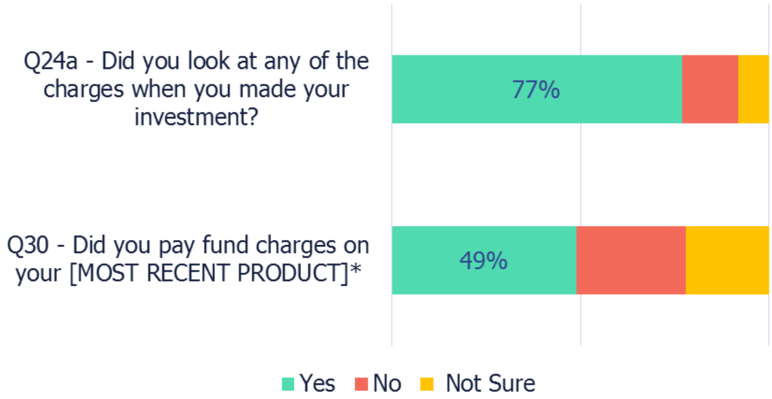
issues about investors' decision making that we cover in the areas of fee structures (Part Three) and governance (Part Five).

3. Retail investor behaviour

Price awareness

74. An important factor affecting price dynamics is investor behaviour and particularly how investors consider and react to price. The Interim Report notes that *"the evidence on whether investors take charges into account is mixed"* quoting the findings that *"most (77%) of non-advised retail investors … looked at charges when they made their initial investment decision and 45% said charges where an influential factor in their choice"*[19]. In contrast, much greater emphasis is placed on the finding that *"more than half of retail investors … did not know for sure that they were paying fund charges on their investment product"*[20] (see Exhibit 5) and qualitative research where respondents mentioned charges only when prompted.[21]

Exhibit 5: Evidence from FCA consumer research on price awareness



(Source: IA presentation of data in Annex 3, Figures 16 and 19, pp.41-42)

75. We explore the consumer evidence in more detail in Annex One and discuss here why it is important to provide greater clarity about the evidence presented in Figure 4.3. The question as to whether respondents pay fund charges on their 'most recent product' is asked of respondents with different investments products, the majority of whom were not direct fund investors but rather direct investors in ISAs and personal pensions.[22] Moreover, this question appears at a place in the survey where there is likely to be some confusion between 'fund' and 'product'.

76. At the same time, it is likely that investors in wrappers may not be aware that their products contain individual funds, as noted by NMG research[23] on non-advised retail investors finding: *"Extremely low awareness that individual funds were contained within products such as stocks and shares ISAs. The majority were under the impression that it was a product rather than a*

[19] Para 4.28, p.49.

[20] Para 4.29, p.50.

[21] Ibid. We do note however that interviewees were prompted to discuss other factors such as performance, risk, liquidity etc. See Annex One for further discussion.

[22] See Annex 3, Figure 2, p.31.

[23] NMG Consulting, The motivations, needs and drivers of non-advised investors, June 2014, p.32.

wrapper and did not know how risk was spread across the individual funds or even that they could have selected these themselves."

77. The Interim Report needs to distinguish between the questions of overall price awareness and awareness of the different components within a product charge if such separate price components exist. For example, pension and ISA providers will charge a single price covering both the pension product/wrapper and particular fund choices within that (particularly for a default fund). Other firms (commonly SIPP providers) will charge one price for the pension product and separate charges for underlying funds. In the former case, respondents would be correct to state that they do not face separate fund charges.

78. We therefore reach a different conclusion. We do not agree that the evidence, as presented in Figure 1.9 and again Figure 4.3, points to the fact that investors are unaware of, or uninterested in, fund charges. This is particularly given the further FCA evidence that 77% of non-advised investors indicated that they look at charges when making their investment decision[24] and that charges were the factor that most investors consider to be influential to their choice.[25]

79. In summary, the FCA evidence points to price awareness even among non-advised investors. It also indicates that there may be some confusion about different kinds of cost through the value chain, including in funds regarding difference between AMC and OCF. We support initiatives to provide both simplicity and meaningful transparency, and discuss this further in Parts Four and Seven.

Choice between active and passive

80. It is strongly implied in the Interim Report that active and passive funds are offered to and bought by different sets of investors. Given the sharper decline in the OCF of passive funds presented in Figure 6.17, it is concluded that *"price awareness and competitive pressure on price is building among certain groups of investors."*[26]

81. We do not accept the inference that there are different sets of investors for active and passive funds. This is not the case in the advised market and FCA research shows that this is not the case for non-advised investors either, with 40% of respondents in the FCA consumer research holding both active and passive funds (so that 60% of respondents invested in active funds also hold passive funds and 74% of those invested in passive funds also hold active funds).[27] Just a quarter of those questioned hold only active funds, and the majority are aware of the difference between the two.

82. This has significant implications for the finding that there is weak price competition in the retail market given that the choice set includes both active and passive funds, and where the FCA has acknowledged there is price competition in passive funds. In other words, if the Interim Report concludes that there is price competition in passive funds, the price awareness and sensitivity

[24] Annex 3, Figure 16, p.41.
[25] Figure 4.2, p.50.
[26] Para 1.19, p.12.
[27] Figure 5, Annex 3, p.33.

expressed in an increase of passive fund assets reflects behaviour of people who are typically invested in active funds as well.

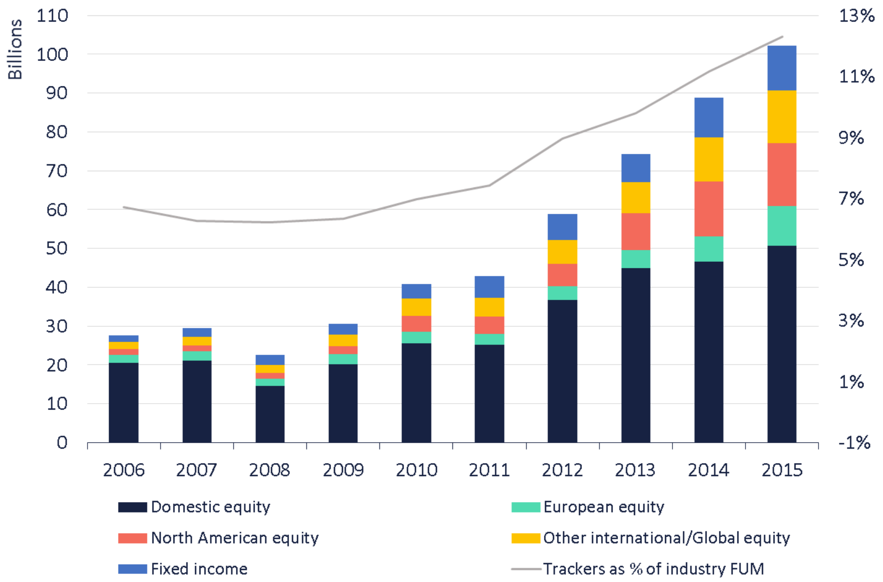
83. It is not only through price trends that investors' price sensitivity can be inferred. We observe the strong rise of assets under management in passive funds over the last ten years, with passive funds accounting for 12% of industry assets in 2015, up from 6.6% in 2005. To get a better sense of what this means, Exhibit 6 below shows that passive fund assets increased from £27.5bn in 2006 to £102.2bn in 2015 – an increase of 271%. This excludes ETFs, which would provide further evidence of the shift to passive amid a widening choice set.

84. This strengthening flow into passive products is not consistent with FCA concerns about the lack of prominence of passive funds in platforms' best buy lists[28] and the rating they are usually assigned by third parties such that investors may not be aware of passive funds being available.[29]

85. At the same time, looking at tracker funds' gross retail sales, Exhibit 7 shows that platforms have been increasingly important over time, with gross sales increasing at a rate of over 50% each year since 2009. As a result, platforms accounted for about 20% of gross retail sales of tracker funds in 2005-2007 but have increased to over 40% in 2015.

86. Overall, the substantial proportion of investors who hold both active and passive funds as well as the increasing investments made in passive funds strongly suggests that price awareness exists in a market that consists of investors who use both active and passive funds. With many of the same customers expressing greater price sensitivity through purchasing passive funds, this will drive competition across the entire funds market.

Exhibit 6: Funds under management of tracker funds by index investment type (2006-2015)

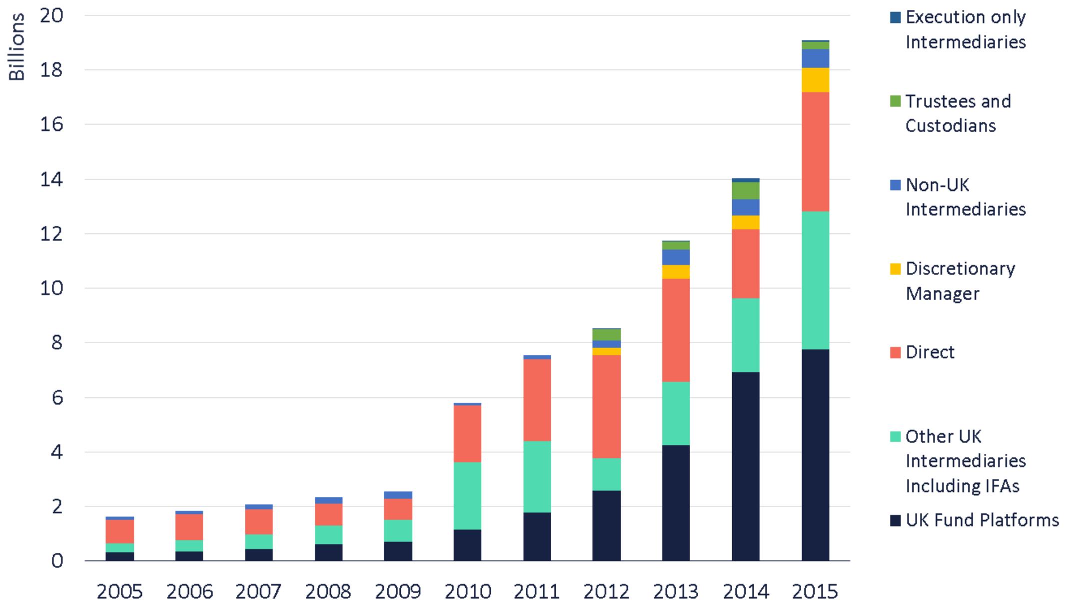


(Source: The Investment Association, Asset Management in the UK 2015-2016, Chart 56, p.61)

[28] Para 4.16, p.47.

[29] Para 4.19, p.48. As a general comment, we would like to understand better the reasons why a higher proportion of funds on best buy lists should be passive funds, given the common investment objective resulting in outcomes will mostly differ to the extent that funds track different indices.

Exhibit 7: Gross retail sales of tracker funds by distribution channel (2006-2015)



(Source: IA fund statistics)

Switching

87. Another aspect of consumer behaviour that could be indicative of competition in a market is the extent to which consumers are able to switch between products. Barriers to switching are generally low, particularly as the prevalence of initial charges is diminishing. However, there is an important issue to resolve with respect to pre-RDR share classes that we explore in more detail in Part Six. Here we focus on the specific FCA analysis and compare it to what we can observe in the retail market.

88. The FCA explored investors' ability to switch[30] in terms of:

- costs that would be incurred (although no further information is provided as to why investors do not switch or whether potential costs are unclear or if they are clear whether they are significant and constitute a behavioural barrier)
- clarity of objectives and delivery (an area we discuss in detail in Part Four of our response)
- barriers to switching platforms.

89. At the same time, switching is closely related to what the FCA describe as *"an asymmetric relationship between net flows and performance"*[31] which is discussed in the context of the Morningstar rating system, where the FCA found that *"5-star rated share classes received large and positive net flows, while 1, 2, and 3-star rated share classes received relatively small negative net flows"*.[32] The ultimate question here is whether investors are switching from

[30] Paras 4.75-4.99.
[31] Para 6.10, p.94.
[32] Ibid.

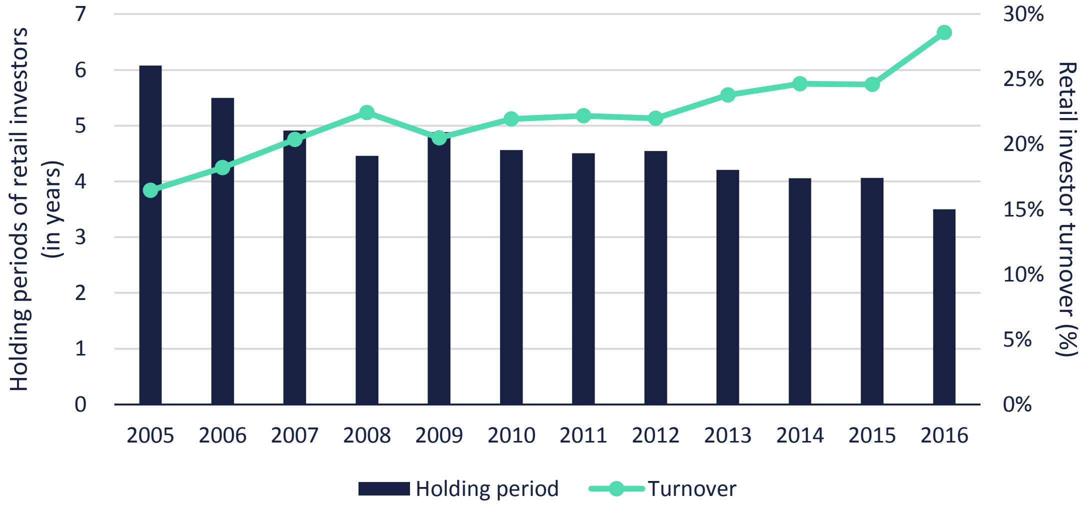
persistently underperforming funds, and what remedies could help investors to do so.[33] The latter point and what this means in a market that is heavily intermediated is discussed in Part Four.

90. As a general principle, information that can help investors make better decisions on fund allocation, including switching to better-managed funds, is a positive in the market. However, there are a range of reasons why some asymmetry in flow may be observed. First, there may be significant new money flows alongside re-allocation. Second, practical considerations arise such as incurring capital gains tax – an issue acknowledged by the FCA.[34] Other reasons could relate to factors as presented in the FCA's consumer research, notably improved performance and the realisation that the consumer is investing for the long term.[35]

91. The latter point is particularly important in the context of funds being generally medium to long-term products with a recommended holding period often being five years or more. This is reflected in the FCA's consumer research where 58% of respondents expected to keep their money invested for more than 5 years and 80% for more than 2 years.[36] So, in a well-functioning market we would expect to see a level of switching but not to the extent where holding periods are too short for funds to deliver on their objectives.

92. In this regard, IA data on retail investors' holding periods suggests a fall from around 6 years in 2005 to 3.5 years in 2016 with investor turnover of holdings increasing from 16% to 29% in consequence – see Exhibit 8. Possible reasons for this pattern could be advances in technology, increasing use of platforms facilitating fund switching, funds that have low or no entry or exit fees, tax considerations of investors in wrapped and unwrapped products, and the increasing involvement of gatekeepers who maintain some form of professional buy/sell rating on funds.

Exhibit 8: Retail investor holding periods at aggregate level



(Source: IA fund statistics)

[33] Para 10.28, p.189.
[34] Para 4.81, p.63.
[35] Annex 3, Figure 31, p.49.
[36] Annex 3, Figure 21, p.43.

93. This decline in holding periods and increase in turnover is consistent with low barriers to switching funds and is not compatible with the Interim Report conclusion that switching is *"fairly infrequent"*, which in turn appears to be based partly on the findings from direct investors who are invested in a range of different product types.

94. The question of switching raises the question of the impact of fund mergers and closures. This is discussed in the context of fund performance in two places within the Interim Report. First, where investors may not be able to look at the (poor) past performance of closed funds giving them the impression that there are fewer poorly performing funds in the market.[37] Second, in the context of how funds respond to persistent underperformance.[38]

95. Taking into account funds that merged or closed is clearly important in terms of assessing aggregate fund performance free of survivorship bias. To the extent that funds close or merge due to poor performance, this should be interpreted as a sign of a well-functioning and competitive market. It is what the FCA describe as 'self-correction' in the marketplace.[39] Mergers and closure of funds are considered further in Parts Four and Six.

4. Fund manager delivery

Investment performance

96. Comparisons between fund returns net of bundled share prices and market benchmark returns are not appropriate measures of fund manager delivery. They provide an indicator of return delivered net of all costs in the retail delivery chain (including costs of distribution and advice). Additionally, comparing active and passive funds on a bundled basis is not like-for-like given that bundled fees for passive funds would typically include a lower amount (if any) for commission. In this regard, RDR provides a welcome structural change that will allow greater visibility of both fund-specific fees and net performance, i.e. how asset managers have really delivered, whether for active or passive funds.

97. We recognise the challenges in constructing the time series performance measures, presented by the FCA in Figure 6.1, and Annex One raises some questions as to the methodology used. These challenges notwithstanding, the performance results are revealing:

- Actively managed equity funds do noticeably better than passive funds even on a bundled fee basis that includes advice and distribution costs.

- Weighted average returns for active equity funds are better than the benchmark net of all costs (including advice and distribution), indicating that the active equity universe as a whole is outperforming.

98. To make this point clearer, we took the weighted average net returns over the benchmark for equity funds as presented in Figure 6.1, annualised them and present them in Exhibit 9. This

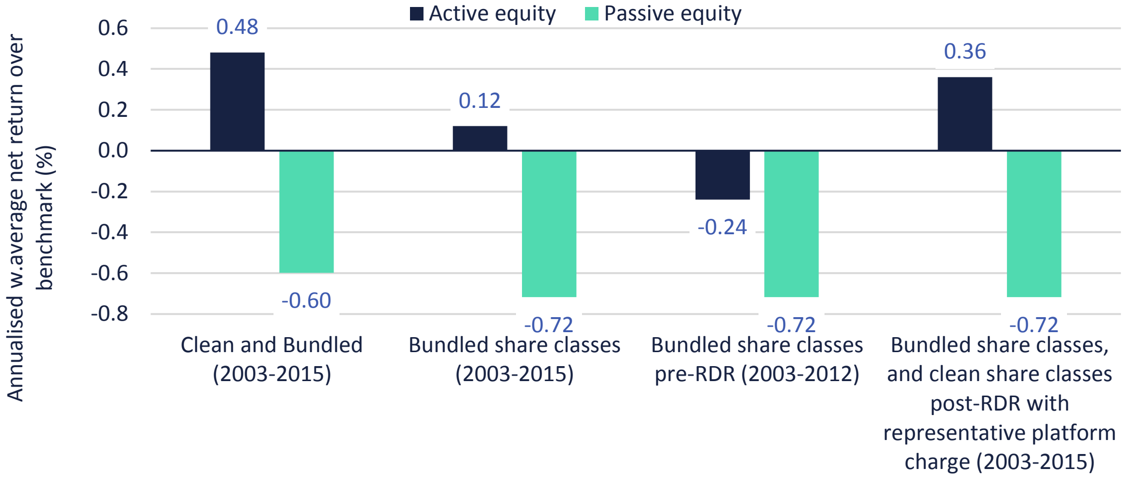
[37] Para 4.40, p.53.

[38] Paras 6.51-6.55, pp.106-107.

[39] Para 6.55, p.107.

illustrates more clearly that this Figure is not consistent with the conclusion that both active and passive funds underperform their benchmarks.[40]

Exhibit 9: Equity funds' monthly net returns over the benchmark (annualised)



(Source: Representation of FCA data in Figure 6.1)

99. These results are aligned with the results of IA analysis published in Summer 2016 showing positive return in excess of benchmark remains net of all costs, including advice and distribution.[41] Particularly for the UK All Companies sector where a further breakdown was carried out between passive and active funds, the evidence showed that active funds outperformed and passive funds underperformed the FTSE All Shares index in each period covered by funds' annual reports between 2012 and 2015.

100. Moreover, the results of both the FCA and the IA performance analysis should improve significantly once we move to an analysis of clean share classes, given that around 75 basis points (50 basis points for trail commission and 25 basis points for platform distribution) would be removed from the fund performance measurement. Exhibit 10 presents our analysis on new primary (clean) share classes.

Exhibit 10: Monthly net returns over the benchmark for clean share classes 2013-2015

			Clean Share Classes 2013 - 2015
EQUITY, FI, Allocation, Alternative	Active	Simple Average	0.08
		Weighted Average	0.16
	Passive	Simple Average	-0.03
		Weighted Average	-0.02
EQUITY	Active	Simple Average	0.11
		Weighted Average	0.19
	Passive	Simple Average	-0.03
		Weighted Average	-0.02

(Source: Monthly net returns over the benchmark from Morningstar. Share class funds under management for the weighted average calculation from IA internal database)

[40] Para 6.26, p.96.
[41] The Investment Association, *Investment costs and performance: empirical evidence of UK fund industry delivery*, August 2016.

101. The results clearly show that based on investment costs only (that is excluding advice and distribution) active management outperformed the benchmark across all asset classes. This is more pronounced if one considers the asset weighted average indicating that more assets are invested in funds that perform better.

102. Hence, the conclusion that active funds underperform compared to benchmarks is not borne out by the empirical evidence. Further, this would also suggest that the model presented in Figure 1.2 of a typical passive equity fund returning 25% more than a typical active equity fund over 20 years appears to be at odds with the empirical evidence of delivery over the past decade or more presented in our analysis and the FCA analysis in Figure 6.1.[42]

'Activeness' vs. outcomes

103. Much of the discussion on the retail market delivery seems to adopt a simplified definition of what active management is and aims to deliver, focusing primarily on stock and securities selection relative to a single asset benchmark, such as the FTSE All-Share. The services of active managers also include risk management, asset allocation, income generation and increasingly outcome-oriented approaches such as absolute return.

104. An important implication of using the narrow definition of outperformance over a benchmark is that it cannot take into account funds that do not have a reference benchmark or funds where tracking an external index is not really feasible. This affects the connection between the analysis that focuses heavily on equity funds and the remedies that would apply to all types of funds.

105. Another important implication is that this affects the discussion around the degree of 'activeness' and the branding of active funds with low tracking error as 'partly active'. The Interim Report defines 'partly active' funds as funds that *"deliver returns similar to a market benchmark over a sustained period of time … may be explicitly constrained by a benchmark or they may be managed in a way which seeks to stay relatively close to the benchmark, and therefore limit any potential underperformance"*.[43]

106. This is very similar to ESMA's definition of 'closet index' funds in its report on the subject[44] where the main characteristic is *"staying very close to a benchmark"* while charging *"management fees in line with those of funds that are considered to be actively managed"*.

107. This is an area that the IA has looked at very closely. As a general principle, we strongly agree with the need to ensure that stated fund objectives and charges align with the nature of the underlying investment process. In terms of quantitative metrics, Annex One discusses in detail this topic, the methodology used to identify closet tracker funds and their limitations, and

[42] Additionally the assumption that a typical active fund has 100% portfolio turnover also appears to be at odds with empirical evidence. IA analysis of Fitz Partners data has found that turnover rates across active equity funds are about 60% on a simple average basis and 45% on an asset-weighted average basis. For UK All Companies funds these figures are closer to 44% on a simple average and 35% on a weighted average basis.
[43] Paras 6.36-6.37, p.99.
[44] ESMA, *Supervisory work on potential closet index tracking*, February 2016.

summarises the results of IA analysis for funds sold in the UK. The main conclusion is that although the three commonly used metrics (tracking error, R-squared and active share) can be used as indicators of a potential issue, they cannot be taken as conclusive evidence. This is mainly because they do not provide any indication as to the outcome that has been achieved. For example, if one considers tracking error[45], a fund may be consistently outperforming the benchmark by the same amount, e.g. 2%, but because this amount does not change, its volatility, i.e. the tracking error, would be 0.

108. The appropriateness of setting any hard thresholds is also discussed in Annex One. We argue that it is not clear why funds with a tracking error of less than 1.5% need to be branded as 'partly active'. From Figures 6.3 and 6.4, we notice that this seems to be the level of tracking error below which are most passive funds. This creates a problem where more active funds would automatically fall into the 'partly active' category if the price or tracking error of passive funds would increase.

109. Our analysis therefore challenges the notion that tracking error (as well as R-squared and active share) can accurately reflect the degree of 'activeness' or that it can in any way predict outcomes. Annex One presents detailed evidence on the connection between tracking error and fund outperformance. The findings do not support the view that low tracking error means that the returns to investors were the same as that of the benchmark nor that high tracking error will guarantee good outcomes.

110. As an example, we split all active equity share classes into quintiles depending on their tracking error and their excess returns and then calculated their average outperformance (net of charges). Exhibit 11 shows that 12% of the share classes in the lowest tracking error quintile were in the top excess return quintile (with outperformance of 4.73%). So a low tracking error does not mean no outperformance. At the same time, high tracking error is by no means a guarantee of outperformance. 37% of share classes in the top tracking error quintile were at the bottom excess return quintile with an average underperformance of -7.65%.

111. Further evidence in Annex One demonstrates that active funds with similar tracking error as passive funds have much higher net excess returns. Additional work would need to determine therefore whether the £109bn which the FCA estimate is in *"expensive partly active funds"*[46] is indeed achieving poor returns. It would be incorrect to assume that investors would achieve better value for money by switching to passive funds.[47]

112. In our view, this topic, as so many others, is ultimately about good disclosure: how objectives are communicated to investors and then the extent to which investor expectations are met. This is discussed in Part Four.

[45] Tracking error is the volatility (standard deviation) of excess return (fund return minus benchmark return).
[46] Para 6.44, p.102.
[47] As stated in Para 6.42, p.101.

Exhibit 11: Tracking error vs excess return for active equity funds, 2003-2015

Proportion of share classes in each quintile combination

	Tracking Error Quintile				
Excess Return Quintile	**Q1**	**Q2**	**Q3**	**Q4**	**Q5**
Q1	17%	14%	15%	18%	37%
Q2	29%	24%	17%	18%	12%
Q3	26%	25%	21%	19%	9%
Q4	16%	21%	29%	22%	12%
Q5	12%	16%	18%	23%	30%

Average excess return for each quintile combination (in %)

	Tracking Error Quintile				
Excess Return Quintile	**Q1**	**Q2**	**Q3**	**Q4**	**Q5**
Q1	-3.55	-4.04	-4.28	-4.75	-7.65
Q2	-1.53	-1.49	-1.52	-1.57	-1.58
Q3	-0.16	-0.12	0.01	-0.08	-0.11
Q4	1.46	1.51	1.47	1.57	1.55
Q5	4.73	4.92	4.70	5.35	7.25

(Source: IA analysis based on Morningstar data)

5. Industry profitability

113. The FCA evidence on AMC clustering and OCF trends in the retail market is connected within the Interim Report to the findings about profitability.[48] This is calculated and presented at firm level (i.e. across retail and institutional). The central finding here, based on a sample of 16 firms, is that operating margins are high and stable across the industry and higher compared to other industries.[49]

114. We explore the FCA profitability analysis in more detail in Annex One but would emphasise three key points:

- Although the finding that the average operating margin has been fairly stable corresponds to IA data[50], it does not tell a complete story with respect to the constituent parts of that average. We have looked at the operating margins of firms with different sizes – ranging from boutique firms with less than £5bn in AUM to large ones with AUM of over £100bn – and have found that there is a considerable degree of variation both between firms and over time.

- Unlike the comparative industry data used by the FCA to look at profitability[51], margins for the asset management cover only the period 2010-2016. Independent data shows in

[48] See especially 6.87, p.116, following the fee analysis of the retail market.
[49] Figure 6.19, p.117 and Figure 6.21, p.118.
[50] The Investment Association, Asset Management in the UK 2015-2016, Chart 77, p.78.
[51] See Figure 6.21, p.118 and Annex 8, Figure 5, p.11.

particular the impact of the financial crisis on fund management operating margins, which fell 31% between 2007 and 2008[52], suggesting that profitability is less stable than suggested.

- The findings on return on capital are particularly susceptible to changes in assumptions. Plausible adjustments (measuring costs including all staff costs and using goodwill estimates from merger experience) result in a return of capital (8.7%) much closer to the range set out by the FCA (5.5%-8.5%).

115. As such, we would like to better understand both the representativeness of the sample used in the FCA analysis and have greater clarity as to the cost of capital calculations and the extent to which these would be indicative of lack of competition. What we observe with a sample of 30 firms is that operating margins are variable across both firms and time.

Conclusion and suggested areas for further work

116. In the context of the structural shift brought about by the RDR, we have shown that:

- There is a downward trend in prices of active funds post-RDR which is expected to continue in the near future.
- Price clustering within similar types of funds is consistent with competition.
- The FCA findings point to investors being aware of and sensitive to prices.
- Price sensitivity can be partly be seen in consumers investing increasingly in passive funds as well as the fact that asset weighted average prices are lower than simple average prices.
- Both FCA and IA analyses point to positive delivery by active funds.
- Profitability varies across firms and changes from year to year.

117. Taken together, these points challenge the conclusion of weak price competition in the retail market. The evidence presented in Parts One and Two of our response describe a dynamic market that is continuously evolving and adapting to changing patterns of demand – characteristics that are not consistent with a narrative of a lack of price competition. As such, a finding of a structurally weak demand side is surprising.

118. One possibility that the Interim Report analysis could consider further is that far more evidence exists for a well-functioning product market, even if there are specific areas which would benefit positively from change. These areas are explored in detail in the following Parts of our response.

119. The IA suggests that further analysis would benefit from a focus on three key thematic areas relating to investor level behaviour:

[52] McKinsey Asset Management Surveys 2007-09.

a. Segmentation of the retail market. An informed DIY investor or an investor using a financial adviser (or a combination of the two) will likely be in a very different position to assess the market and their individual needs to a semi-informed and/or unadvised investor. While we welcome the FCA's consumer research to ascertain the behaviour of non-advised investors, this cannot be generalised across the market given the importance of IFA distribution in the UK retail market.

b. Role of charges through the value chain. The Interim Report emphasises strongly the finding (Figure 1.9) that only 49% of non-advised consumers reported paying fund charges on their most recent investment product. It gives less prominence to the finding that 77% of the same group reported looking at charges when buying an investment product, of which 72% specified that they look at ongoing fund charges. The apparently contradictory finding about fund charges in a product may reveal a degree of confusion about the question in the survey rather than a lack of awareness per se.[53] The only clear conclusion, in our view, is that further work is needed on how different charges, including the fund OCF, within the chain are explained and communicated.

c. Consistency of presentation and product regulation. Respondents to the FCA consumer research held a range of products via a range of vehicles, identified in the questions as including investment trusts and ETFs. While investment funds clearly do account for the majority of retail market delivery, they are not the only product, as is acknowledged but not explored in detail in the Interim Report analysis. Furthermore, in the institutional market, pooled delivery is often via a unit-linked life vehicle. As we set out in Part Seven, the IA's approach to consistency of disclosure is to seek a common framework across the product market served by investment managers. The FCA should consider the implications of this for all areas considered in the Interim Report.

120. Further research on the demand side may therefore help to provide further support on the nature of necessary remedies, including the balance between supply and demand side remedies. This is particularly important because if only supply side remedies are applied it is not clear how and to what extent this will empower investors to take better decisions and arrive at better outcomes. Investor education will probably have a major role to play in this respect. Additionally, a central focus should be the valuable role that intermediaries can and do play. Looking particularly at the segmentation point would help better to establish the balance needed in remedies between supply and demand side interventions in the retail market.

[53] This observation is supported by the confused response to a more detailed follow up question about AMC v OCF, which supports the existing FCA and IA guidance on displaying OCF rather than AMC. The implication of the findings is that this is not followed across the whole market, supporting the extension of the concept beyond investment funds into other parts of the long-term investment and wrapper market.

PART THREE: INVESTMENT FUND FEE STRUCTURES

Summary

121. Transparency of charges and costs across the long-term savings market is a pre-requisite for building consumer trust. This Part analyses the Interim Report's findings and proposed remedies, particularly given concerns about the incentives on managers to control different types of costs. We conclude that a single charge based on the OCF could provide a simpler proposition for customers to understand the cost of the professional service, alongside better disclosure of the transaction costs needed to deliver a return for customers. We also put forward proposals on presentation, linking to the new IA Disclosure Code, which will deliver a comprehensive and consistent charge and cost accountability framework.

Section 1 – Overview of Interim Report findings

122. The FCA analysis finds that control of ancillary costs within the OCF are transparent and procurement of ancillary services *"broadly appropriate and effective"*.[54] Concerns are raised that some firms are not exercising sufficient control of transaction costs. This point is linked to issues both of transparency and associated manager incentives. The Report also identifies other areas of concern, notably box management.

Section 2 – Nature of charges and transaction costs

123. We distinguish between three kinds of costs: fees paid directly to the fund manager, fees paid directly to third party providers and transaction costs incurred in the market in order to deliver an investment return.

124. Two important points emerge here that are fundamental to our response, given the importance of well-aligned incentives and meaningful disclosure:

- The OCF (combining the first two categories of cost in Para 123) is a key indicator of the costs of investing in markets via a fund as opposed to investing in markets directly. Product charges expressed through the OCF have a linear relationship with the return of a fund, reducing it in proportion to the fee levied.

- Transaction costs have an entirely different relationship with investment return. While high unit costs per trade will erode returns, high or low overall volumes of trading may result in strong or weak performance so that there is no linear link between the two.

Section 3 – Fee structure remedies

125. Options A and B (OCF as single charge) can provide simplicity and predictability for fund investors, and the existing direction of travel on transaction cost disclosure means that Option B would be the more likely way forward of the two options. While there are a number of potential unintended consequences to consider, we see no fundamental problems with this

[54] See summary on p.122 of Interim Report.

approach. We note, however, that the evidence presented suggests that ancillary costs within the OCF are generally managed satisfactorily and therefore that the justification for Options A and B is primarily one of simplicity of presentation.

126. The Interim Report has put forward two approaches to address the area it considers most problematic: control of transaction costs. One is a disclosure route (Option B). The other is a structural change which introduces a single charge including transaction costs (Options C and D). In our view, the latter effectively signals a pre-defined cap (with varying degrees of severity) on investment activity by the manager within a single charge. This raises a critical point about the fundamentally different nature of charges compared to transaction costs, and the agency incentives that already exist on managers to deliver investment return on behalf of investors.

127. A key market structure question also needs to be considered alongside the incentives discussion: how to deduct costs that cannot precisely be expressed in pounds and pence in a set of fund accounts? Current market structure makes it near impossible to envisage an accurate system of removing estimated spread impacts from investment return in order to levy a single charge that includes a fixed expression of that spread. Options C and D would require this unnecessary complication.

128. Taken together, these points suggest that enhanced reporting of transaction costs by investment funds, combined with supervision of best execution obligations at the level of the underlying asset manager (whether within or outside the same group as the fund) should, in our view, address FCA policy and supervisory concerns. The issue of research costs will be addressed under MiFID II.

Section 4 – Consumer presentation and comparability

129. The way in which charges and transaction costs operate needs to be better communicated to consumers as part of the enhanced reporting of costs. Recomposing an example used by the FCA in the Market Study, we show how a combination of metrics and narrative may help consumers understand charges and costs better. Forthcoming European aggregation requirements for OCF and transaction costs were not based on robust consumer testing and additional work should be done in this area to facilitate meaningful disclosure.

Section 5 – Box management

130. The manager's box is a mechanism that facilitates the matching of unit transactions outside the fund itself, and never operates to the detriment of the performance of the fund. This issue is sometimes addressed in bilateral supervisory discussions between firms and the FCA. The Market Study offers the opportunity for clarification of FCA expectations at a rule-making level.

1. Overview of Interim Report findings

131. The Report analysis finds that control of ancillary costs within the OCF are transparent and procurement of ancillary services *"broadly appropriate and effective"*.[55] Concerns are raised that some firms are not exercising sufficient control of bundled research costs as well as transaction costs.

132. On the issue of use of dealing commission for research procurement, the Interim Report finds that firms have improved control over research costs; that overall spending on research and execution has decreased since 2012; that the majority of firms sampled now set budgets; and that firms are starting to prepare for the fundamental change ahead under MiFID II which will see transaction costs unbundled from research costs. However, the FCA notes ongoing concerns about the rigour and oversight currently being applied ahead of MiFID II.[56]

133. The findings on best execution were based on a review of eight firms in 2016, some of which had demonstrated a decrease in the cost of equity trading. However, the Interim Report notes that "not all firms" could show improvements in their execution process, with some market structures making this more difficult for firms.[57]

134. The specific issue of controlling cost per trade which lies at the heart of the Report's best execution analysis is linked implicitly in the proposed remedies to decisions on overall volume of trading, which involves wider factors such as investment decision-making and investor flows. The Interim Report considers how to *"increase the visibility of all charges taken from the fund and impose more discipline on overspend"*.[58] This is on the basis that *"some charges, particularly transaction costs are not disclosed to investors before they make their investment decisions"*.[59] As a result, *"investors bear the risk of the actual charges being different from that estimated by the fund manager"*.[60]

135. This suggests two points are being made in the Interim Report: first, that investor decision-making could be enhanced by additional information about transaction costs prior to investing and second, that investor outcomes could be improved because managers are currently not sufficiently incentivised to control costs.

136. In principle therefore, the Interim Report links the incentive to control transaction costs to their visibility to investors and their impact on net performance.[61] In practice, the FCA observes that investors are indeed sensitive to past performance but goes on to conclude that firms place less emphasis on controlling transaction costs.

[55] See summary on p.122 of Interim Report.
[56] Paras 7.56-7.59.
[57] Para 7.61-7.65, p.137-8
[58] Para 10.18, p.186.
[59] Para 10.16, p.186.
[60] Ibid.
[61] Para 7.27, p.129.

137. Finally, the Interim Report identifies the existence of one category of box profits ('risk free box profits' where they arise) as an area of concern.

2. Nature of charges and transaction costs

138. There are three broad categories of costs within funds:

a. Fees paid directly to the fund manager, which comprise the annual management charge and sometimes an additional administration charge. Some of these fees are used to pay for activities delegated by the fund manager to third party service providers. These fees are nearly always calculated as a percentage of net asset value.

b. Fees paid directly to third party providers, which comprise all other operating expenses and remuneration of parties providing services to the fund. These fees may be calculated by reference to net asset value or an alternative method such as a charge per transaction or a flat fee.

c. Transaction costs, which are necessarily incurred for acquiring and disposing of the fund's underlying investments and comprise transaction taxes such as stamp duty, brokerage commissions and costs implicit in the bid-offer spread. Transaction costs are determined by reference to the value traded. Implicit transactions costs do not constitute payments taken from the fund, but rather those costs that are encountered in the market as an economic friction.

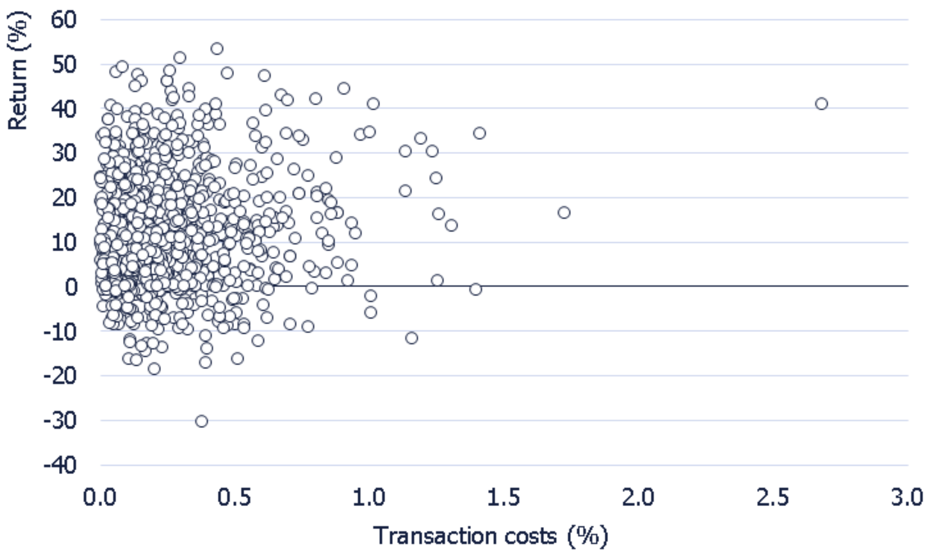
139. For disclosure purposes, the fees paid to the fund manager and third party providers are combined into a single figure; the ongoing charges figure (OCF). The OCF represents all the costs of investing in markets via a fund as opposed to investing in markets directly. These costs are a drag on performance and their impact is directly proportional to the rates charged. Higher charges equate directly to lower net returns, e.g. a fee of 0.25% will reduce the return accordingly.[62]

140. In contrast, transaction costs are incurred to gain exposure to the market or to change exposure in order to develop performance. A higher unit transaction cost will reduce the return achieved from an individual trade. However, it is not necessarily the case that higher aggregate transaction costs will represent a greater drag on overall performance since the primary determinant of transaction costs is the volume of trading and the positions that result from that trading determine the overall performance. Conversely, lower aggregate transactions costs will not necessarily result in better overall returns because the reason for the lower transactions costs could be a failure to make a trade which would have been performance enhancing. An individual fund could therefore incur high transaction costs and achieve strong or weak performance. Equally, low transaction costs could produce the same variation in

[62] For any given fund's gross performance, higher charges directly reduce net returns compared to lower charges with the same gross performance. This is not to say that when comparing across funds, those funds with higher charges will have lower net returns.

returns. The point is, there is no causal link between transaction costs and performance – see Exhibit 12.

Exhibit 12: Annualised net return against explicit transaction costs, 2012-2015



(Source: IA analysis based on Fitz Partners and Morningstar data)

141. This has major implications for disclosure, as we explore in more detail below. We have long been advocates of full disclosure of transaction costs to help fund investors understand the economic costs of the investment return that they are paying for. In 2012 we issued guidance setting out standards for transaction cost disclosure and introduced mandatory requirements in 2014 as part of the SORP. Moreover, we are now well-progressed on delivering an approach to the disclosure of transaction costs that will help a broader range of investors. However, bundling of these costs with the OCF is neither appropriate nor will it help investors.

142. This discussion is relevant on an international level too. The fundamental model of fund management internationally allows both retail and institutional investors to delegate to a professional agent an investment process that they may otherwise choose to undertake themselves (and where they do undertake it themselves they will incur transaction costs in their selected markets on their own behalf). Visibility of the charge for that service, as opposed to the transaction costs for accessing the market, is essential. This is particularly the case in the institutional market where the decision to outsource or in-house the investment process is a more viable prospect than for retail investors for whom some markets are wholly inaccessible for both scale and regulatory reasons.

143. The agency issue needs careful practical consideration as well. The FCA proposed remedies do not distinguish between fund manager and portfolio manager. In practice, the portfolio manager is subject to detailed regulation regarding the associated responsibilities, including best execution. We return to this point in paragraph 165 to 166.

3. Fee structure remedies

144. The Interim Report is proposing to introduce a single all-in fee in order to incentivise fund managers to control charges more effectively and facilitate better investment decisions by investors. This may be coupled with additional disclosure requirements to encourage investors to focus on charges.

145. As a general point, the potential implications of having different models of fee structure in different parts of the pooled fund market should be considered, not least because in many cases retail and institutional investors will be accessing common sets of funds and investment processes. The scope of discussion should extend beyond authorised investment funds, particularly given the importance of other delivery mechanisms such as unit-linked products in the pensions market, both DB and DC. From a consumer clarity perspective, consistency should be a key objective of regulators and industry as far as possible.

146. Also, a number of past and current initiatives remain in transition which should too be taken into account. The effects of the RDR are still to emerge fully with significant amounts of money remaining in pre-RDR arrangements. The evidence base in the Interim Report demonstrates how difficult it is to draw robust conclusions as RDR has still to work its way through. Moreover, significant changes to the disclosure regimes for all types of retail product are due to come into effect at the end of 2017 as a result of MiFID II and PRIIPs. To a large extent these will deliver the remedies anticipated by the Interim Report in respect of additional information that includes transaction cost disclosure. Until the results of these initiatives and their implications for the behaviours of both investors and asset managers can be observed, it cannot be known whether further remedies are necessary or desirable.

147. The options for the all-in fee are constructed around three core components:

- The current OCF becomes the single charge (options A and B).
- Additional disclosure of a transaction cost estimate (option B).
- A single charge including transaction costs (options C and D).

The current OCF becomes the single charge

148. Fund managers currently disclose to investors a single figure for all charges taken from the fund: the ongoing charges figure (OCF). In our view, the OCF is a regulatory success: the simplest and most meaningful way of providing investors with a comprehensive charge figure before they invest. We understand that the majority of charges included in the OCF are calculated as a percentage of net asset value so the extent to which actual charges will deviate significantly from the published OCF appears to be limited. Therefore, the current risk of investors experiencing higher than expected charges would already seem to be low.

149. The FCA's central evidence on OCF appears to vindicate the current model in that it concludes both that *"most third party costs are transparent to investors"*[63] with the exception being transaction costs and that *"competition appears to be working effectively in most ancillary service markets, allowing asset managers to control costs and quality"*.[64] Given this evidence that fund managers control ancillary costs, the question therefore arises whether a single OCF addresses an incentive problem that is already appropriately managed and what the implications are for disclosure of components within that (i.e. split between management charge and other costs).

150. Nonetheless, we recognise and support the simplicity for consumers that can be delivered through the OCF becoming a single charge and some fund managers have already moved to such a single charge approach. We understand this has been done in order to simplify the cost structure and make it easier for investors to understand. We also understand that this approach has caused the FCA to be concerned that fund managers might profit from savings or economies of scale on fixed-cost services provided by third parties. To address these concerns, these fund managers have needed to establish procedures to monitor and pass any significant savings on third party fees back to investors through a reduction in the single charge rate.

151. Although we see no major structural impediment to a single charge based on OCF, the FCA should be aware that there are some practical implications for the single charge, notably in the following areas:

- <u>Variations in fee levels</u>. Managers must retain the ability to reduce or increase fees in certain circumstances, which means that this approach may only give certainty about charges in respect of timeframes much shorter than the likely investment horizon. As the FCA notes,[65] it is possible that firms will wish to reduce business uncertainty arising from variations in cost, which might result in a higher headline OCF. However, given other competitive pressures appearing in the post-RDR environment, with firms reporting intensifying pressure on margins, there is likely to be significant market challenge to any increases in the OCF.

- <u>Fund of funds</u>. Multi-asset funds are often delivered through fund of funds structures. Tactical asset allocation decisions may result in shifts to parts of the market where the underlying components are more expensive in terms of OCF. Within the existing model, where the OCF can adjust, this is manageable in a way that is compatible with incentives to maximise risk-adjusted return. Firms would likely wish to avoid a situation where a pre-committed OCF at the top level of the fund creates a potential disincentive to managers to make allocation shifts. In other words, as we argue below with respect to transaction costs, manager incentives to deliver the best possible outcomes for clients should not be inadvertently compromised by changes to regulation.

[63] Para 7.22, p.128.
[64] Para 7.35, p.131.
[65] Para 10.20, p. 187.

- Property funds. The physical nature of this asset class is such that expenses are far less predictable than in securities funds. The principal return from property is the rental income stream achieved by leasing commercial premises to tenants. Usually tenants pay for services to the premises such as utilities, security, technology and access. In the event that a tenancy is terminated, the building may be empty for a period in which case the landlord (the fund) is obliged to pay the continuing service costs. Moreover, further expenditure may be required to refurbish a premises for re-letting. . If such expenditure is constrained through the OCF, this could make it more difficult to manage property to its maximum potential. For example, it could create incentives to let to a lower quality tenant or to accept a lower rental income rather than incur the additional expenditure needed to secure higher quality and rental.

152. Within the OCF paradigm, the FCA also has the option of strengthening the existing requirements to consider only the OCF in retail marketing. The longer term history of UK fund charges suggests that the separation between expenses to the fund (e.g. payment of corporate trustee in unit trusts) and the management fee was regarded by regulators as desirable on the basis that a separation would help ensure clear controls.

153. In this regard, there may be a trade-off between the simplicity of the single charge from a consumer perspective and wider transparency. Currently, investors are presented with the OCF and are able to drill down to find out the more granular cost components if they want to. Although the FCA found fees paid to the fund manager are generally by far the largest component of the OCF, in property funds and multi-manager funds the third party costs were found to be at least as significant. This granularity appears to be particularly important to institutional investors who rated management fees as the most important decision-making factor. This accords with FCA research indicating that management fees are a key concern for institutional investors.[66]

154. Finally, it is not clear in the Interim Report if a view is taken on the merits of performance fees in the proposals. We would welcome further clarity in this area.

Additional disclosure of a transaction cost estimate

155. The IA has for some time supported greater accountability for transaction costs. In 2012, we issued guidance setting out standards for transaction cost disclosure and introduced mandatory requirements in 2014 as part of the SORP. More recently, as the Interim Report acknowledges, the IA is developing a comprehensive framework that will applies to all investment products and services (see p.94).

156. Moreover, regulatory solutions are already in the pipeline in the form of PRIIPs and MiFID II, both of which will require disclosure of transaction costs at the point of sale.

157. Although disclosure is not the same as fixing the level of transaction costs, the intention to compare them raises questions that still need to be tested as to how investors interpret and act on transaction cost information in the context of their investment decisions.

[66] See Annex 5, Figures 14 and 15, pp.15-16.

158. In particular, it is not clear from existing evidence that there is widespread understanding about the distinction between product charges (which, all things being equal, will always erode return and in a linear fashion) and transaction costs (which have a non-linear relationship with return and are necessary to deliver performance in any market).

159. The industry recognises that it needs to do more work, together with other stakeholders, to communicate how transaction costs work. We also accept that full transparency of transaction costs should be the norm for all products and services markets served by the fund and asset management industry. As we comment in Part Four on disclosure, more work needs to take place on exactly how next generation disclosure documents operate. A degree of work was undertaken in the context of the PRIIP KID, but the findings from this have not been implemented in regulatory technical standards to date.[67]

A single charge including transaction costs

160. The Interim Report implies that fund managers are not sufficiently incentivised to control transaction costs and references two areas of concern: research and best execution.

161. In respect of research costs, the FCA notes that its recent supervisory work revealed positive findings about the direction of travel in controls of research costs such as setting research budgets, and in the level of research and execution spending which has decreased. We would emphasise the significance of the changes ahead under MiFID II which will move to unbundle execution and research costs and which are expected to address any remaining concerns surrounding research costs.

162. The central evidence on best execution relates to supervisory work with eight firms in 2016.[68] The findings, which we believe would benefit from further detail, suggest that the key to reducing trading costs is having in place an effective governance process that ensures appropriate review and challenge is applied to the trading strategy.[69] We agree with this analysis with respect to review and challenge, and that discharge of best execution obligations should be subject to supervisory oversight.

163. MiFID and MiFID II already impose detailed regulatory requirements in this area. Importantly, existing MiFID best execution requirements (as expressed in COBS 11.2) are defined in broader terms than simply costs, requiring that investment firms take all reasonable steps to obtain the best possible result for their clients, taking into account the following execution factors: price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of an order. As we note in the previous paragraph, failure to meet the MiFID best execution requirements should be addressed through supervisory oversight.

164. The proposed remedies on transaction costs take a different direction to that suggested by the (improving) findings on best execution. The concern about manager incentives appears to lead

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[67] London Economics / IPSOS*, Consumer testing study of the possible new format and content for retail disclosures of packaged retail and insurance-based investment products*, 2015.
[68] Para 7.61, p.137.
[69] Ibid.

to the remedy of a single charge including transaction costs (Options C and D). There are a range of issues here that raise very significant concerns about how this approach will deliver good outcomes for investors, either at the level of manager incentives or ex ante consumer disclosure. We set them out below. They hinge on the following observations:

a. There is a key difference between the cost per trade and the aggregate cost of trading.

b. Cost per trade relates to best execution requirements and there are limitations to what is within the direct control of the manager as well as a regulatory definition of best execution based on a range of factors and not only cost. However, within the best execution requirements, managers have both a regulatory obligation and an agency incentive to control cost per trade in order to maximise return. The question being addressed is: "Given the instruction to trade, are the costs being managed effectively?"

c. The aggregate cost of trading is driven fundamentally by something different: the volume of trading. An incentive to manage aggregate transaction costs by reducing trading volume may compromise any given investment decision. Such a decision should be based on its potential to contribute to the overall net return and the positive impact of a trade is maximised by control of the cost per trade. While reducing the cost per trade will necessarily improve the return, trading volume itself has no intrinsic connection with return. High volumes may help to facilitate strong returns, or result in weak returns. The same is true with low volumes. This is illustrated in Exhibit 12 on p.42.

d. This has major implications for fee models, as well as the presentation of cost since aggregated charge and transaction cost presentation is flawed as a result of point (c). The mixing of a charges metric (the OCF) which is a direct and linear drag on returns with an entirely non-correlated cost within the return (aggregate transaction costs) makes comparisons between funds exceptionally challenging. It can potentially serve to mask what the fund manager (and those delivering ancillary services to the fund) are actually earning from the services provided. The latter is only visible in the OCF, however it may be structured.

Controlling cost per trade

165. We recognise that best execution on behalf of clients is important. Furthermore, many firms invest significant resource in ensuring that these obligations are met. However, there are limits to the extent that fund managers can exert downward pressure on costs per trade. Although broker commission rates can be reviewed and negotiated, transaction taxes such as stamp duty, which are the most significant element within explicit costs of UK equity trading, are not within the control of the fund manager (nor more commonly as this role is delegated, of the investment manager).[70] Moreover, independent research carried out for the FCA by Novarca in the context of the debate on transaction cost disclosure in workplace pensions notes that spread and implementation shortfall cannot be controlled directly by the investment manager

[70] FCA, Transaction cost disclosure in workplace pensions, CP16/30, Section 3.8, p.13.

given that they are an inherent part of a market structure.[71] While firms can take steps to identify the trading location that minimises the spread and implementation shortfall (whilst taking into account other requirements under best execution), they do not have the ability to control the overall level of these effects.

166. The FCA estimates that total equity transaction costs can add around 50 basis points[72] and broker commission is 17 basis points.[73] Therefore it would appear that currently only a third of the cost per UK equity trade is within the negotiable control of the investment manager – the remainder being stamp duty and implicit costs. In 2018, MiFID II will unbundle execution and research fees and require managers either to pay for research themselves or to charge clients a fixed research budget not linked to the value traded. Either way it will cease to be a transaction cost. According to ITG, broker commission rates in UK and Europe cluster around 2-6 basis points of the value traded for execution only services and 14-16 basis points for bundled services. [74] This implies broker commissions might be expected to fall from 17 to 5 basis points of net asset value and similarly total transaction costs might fall from 50 to 38 basis points. Overall, this would leave investment managers in a position to negotiate over one eighth of the cost per equity trade (5 bps out of 38 bps).

Trading volume and the nature of manager incentives

167. With such potentially limited ability to control the cost per trade, it may be argued that the only way fund managers can control transaction costs is to ensure there are fewer trades. Including transaction costs in a single figure that cannot be breached, amounts to setting a budget on trading activity that could incentivise fund managers to instruct their investment managers to avoid trading in order to keep proprietary costs down. While some commentators would see this as a positive development, IA analysis has found aggregate turnover in funds to be far lower than often suggested.[75]

168. More fundamentally, the IA has always argued that there is no incentive to over-trade given the nature of the current fee model: i.e. fund managers are incentivised to deliver the best possible return on a risk-adjusted basis, or a specific outcome in the case of more solution-focused products. Were the incentive structure to be changed as per Options C and D, our initial observation would be that there might be an increased risk of missed opportunities to make gains or limit losses on behalf of clients. In particular, if the effect of additional trading is to push asset managers beyond their trading budget for a fund and into a potentially

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[71] Novarca, Transaction costs transparency, December 2014, p.15. Novarca use the term 'implementation shortfall' to represent the change in the price (i.e. slippage) between a benchmark price at the commencement of a transaction and the actual price at which it is executed. A number of different benchmark definitions are used for different purposes.

[72] Para 1.29, p.16. We are unclear what data has been used to derive the 50 basis points and would welcome clarity on this point. If it is linked to data presented in Annex 7 we note this data shows considerable variation according to the sample used e.g. Figures 2, 5 and 6 have different average charges for different samples of firms.

[73] See Annex 7, Figure 12, p.15.

[74] ITG Peer Analysis, Global cost review, Q4 2015.

[75] Investment Association, Investment costs and performance: Empirical evidence of industry delivery, August 2016.

proprietary loss-making situation, then asset managers might face a perverse incentive not to trade (to avoid making such losses) even though trading may be to the benefit of their investors. Ultimately such a cost structure could create irreconcilable conflicts between the asset managers' respective duties of care to their clients and their shareholders.

169. This is not just an industry view. In September 2013, the Office of Fair Trading published the DC Workplace Pensions Market Study which recommended disclosing a single charge covering all costs and charges.[76] Significantly, it recommended excluding transaction costs in order to prevent such conflicts of interest arising. Indeed, the Interim Report also acknowledges that the proposed remedy may cause fund managers to trade less than is in investors' best interests. It would be helpful to have more commentary from the FCA about the basis for the different conclusion reached in the Interim Report.

Practical issues of fee and performance calculation

170. While there are always solutions for practical challenges, we emphasise that the challenges in this area are unusually difficult. This is due in particular to the existence of implicit costs, which derive from external market structures and not investment management fee structures.

171. Fund charges, whether in the form of a single charge or a collection of separate charges, are calculated and booked in the accounting records each day and as such reduce the net asset value. In contrast, transaction costs arise and are paid as part of the consideration for each trade. Therefore the accounting records reflect the actual cash paid or received by the fund each time a transaction is applied to the investment ledger.

172. A single charge including transaction costs would require an unprecedented level of operational process re-engineering in order to avoid double charging. This could only be done by creating an entirely new international settlement process involving brokers and custodians such that separate cash payments are made by the asset manager for the brokerage and tax components of the consideration for each and every trade. Alternatively, an equally complex and granular process would be needed for the fund manager to make cash rebates to the fund to offset the transaction costs incurred; it would be necessary to analyse the contract note of every equity trade on a daily basis to calculate and process the rebate for explicit costs within the daily unit pricing window.

173. This would be exceptionally challenging, not least from a timing perspective. However, an even more fundamental problem would arise in respect of implicit costs. Additional data (e.g. spread or arrival price) that is not currently part of the contract note would need to be collected. In theory, this is conceivable and it would be possible to combine such data with the details on the current contract notes in order to calculate and process a rebate for implicit costs. In practice, and as the FCA has observed,[77] the majority of firms rely on third party providers for their transaction cost analysis capability. It is difficult to envisage how third party market data

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[76] OFT, Defined contribution workplace pensions market study, September 2013, p.25.
[77] Paragraph 22 of the cost benefit analysis for CP16/30.

feeds could be obtained, processed and fed into the necessary calculations and control procedures within the available pricing window. Nor would it alter the outcome for investors.

174. It is the processing of this 'rebate' that exposes the major difficulties in clear delivery and accountable consumer outcomes:

- Implicit costs do not exist in cash terms in the same way as brokerage or stamp duty. They are embedded in the valuation of an individual stock or security and have to be estimated, which resulted in the recent FCA consultation (CP16/30) on methodology.

- The single charge implies that such an estimate would need to be made, which in less liquid parts of the market, could be subject to a significant degree of approximation.

- This estimate would then need to be rebated to create a theoretical 'cost free' return. Such a rebate has to be done to avoid a double count when a new all-in fee (including transaction costs) is applied.

- A hard cash fee (the new all-in fee including transaction costs) would then be applied against the 'cost free' estimated return.

- The relationship between this estimation and a fixed fee is extremely unclear, and may in turn distort incentives in a way that leads to yet further complication in the transparency debate. The IA has concerns about a process in which notional figures are created on which real charges would be based.

175. This difficulty is not a consequence of asset management systems, but of market structures that managers navigate on behalf of savers and investors. While the incentives existing under the current model (see Paras 167 - 169 above) still represent a fundamental reason not to proceed with a single fee including transaction costs, these practical challenges also need to be considered.

176. Furthermore, it would not work from a competitive position to require just that explicit costs be considered since this will distort customer perceptions of true market costs: for example, a bond fund will sustain transaction costs, but those costs are not explicit in the same way as brokerage or transaction taxes in equity markets. If regulators take the view that implicit costs are true costs to investors, the logic of the argument would be to consider explicit and implicit costs together which can be done using estimates produced under an appropriate disclosure framework.

4. Consumer presentation and comparability

177. The IA position historically has been to ensure that the fund management charge is clear and comparable, and we are working towards complete disclosure of transaction costs (see p.94). This position has also been echoed across different parts of the market, particularly by advisers and institutional clients. Bundling the cost of asset management with the cost of trading makes identifying the cost of asset managers more difficult and less comparable than providing information separately on asset management and the cost of trading.

178. To our knowledge, no extensive consumer testing of composite models such as Option D has taken place, but we would be interested to gather evidence as to how behaviour – and hence competition – might be affected across the funds market. For example, would small cap funds or other markets with higher spreads start to look 'expensive' relative to more liquid markets? Would a high turnover strategy in any market look 'uncompetitive' relative to lower turnover strategies? Would multi-asset funds with their ability to move their investors' exposure between asset classes become 'priced out'? The IA would like to consider in detail the practical impact of Options C and D on investor behaviour within and across product and asset class segments should these options be pursued.

179. To explore how better to communicate the difference between product charges and transaction costs for customers, we use the assumptions presented in Figure 1.2 of the Interim Report, which illustrates the different impact of a theoretical set of fees and costs over a twenty year holding period (see Exhibit 13):

- In this model, the passive fund returns 6.34% a year as does the active fund after transaction costs. The passive fund has incurred 0.1% of transaction costs as per the example in the Interim Report and the active fund has incurred 0.5% of transaction costs. Crucially, transactions occur above the green return line and not below it because the return arises as a result of the transactions.[78]

- A return of 6.4% is therefore an outcome to which no further transaction costs could be added for the purposes of accessing the return from the basket of stocks and securities. Transaction costs have already been incurred.

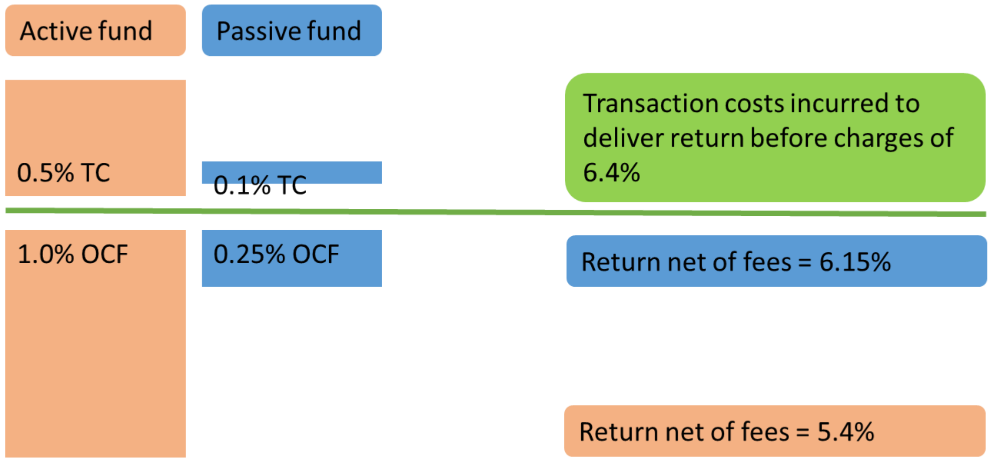
- This return (6.4%) will then attract fees in the form of an OCF, which contains fees paid directly to the fund manager and associates, and fees paid directly to third party providers.

- The passive fund in the FCA example has a lower OCF (0.25% against 1.0% for the active) and the investor is theoretically around 24% better off over twenty years assuming an identical return and not the 44% that the FCA suggests. We note, however, that the empirical evidence in the FCA report suggests that active equity fund investors would be better off by around 1% each year over the 12 years measured (2003-2015) after all costs, including distribution and advice.

180. This is a standard approach to explaining transaction costs and a reflection of the way in which an index replication would take place in an investment fund: i.e. it would be necessary to incur transaction costs (stamp duty and brokerage) to obtain a return, against which a fee would then be charged.

[78] So that the two lines in FCA's Figure 1.2 that present returns net of ongoing charges figure and transaction costs are theoretically impossible.

Exhibit 13: Relationship between investment return, transaction costs and charges (Figure 1.2 recomposed)



181. The industry and regulator should work together to consider the major implications for presentation of performance and cost that arise from this example. We do not agree with the FCA interpretation that the passive return would be 44% higher. This is impossible theoretically and is also out of line with empirical evidence presented in the Interim Report.

182. We are concerned that aggregate reporting of charges and costs under MiFID and PRIIPs will lead to such conclusions being made by investors, regardless of whether the aggregation expresses a single fee or a collection of components. Although the single fee including transaction costs is fundamentally different at the level of changed P&L risk for the managers, the potential distortion of incentives for both managers and investors arises in a disclosure aggregation as well.

183. The IA fundamentally disagrees that aggregation provides meaningful disclosure for this reason and believes that the illustration of Figure 1.2 should be translated into a workable narrative that simplifies the retail experience. For example, drawing on the metrics above:

- *In delivering a return of 6.4% before fees, the manager incurred transaction costs of 0.5%. These were broadly similar/different to the preceding period because….. and reflecting similar/changed levels of portfolio turnover and/or market conditions. In general, transaction costs in the market(s) in which this fund invests are higher/lower than those typically seen in other markets because….*

- *Our fee for delivering this return of 6.4% is 1.0% levied as a proportion of the average value of the fund over a year. This fee represents the cost of operating the fund for the benefit of the many individual investors who access it on a collective basis.*

184. We fully accept that this may not be straightforward for some customers, and recognise that further work is needed. However, simplicity of data should not be equated with comparable and meaningful information. This is the problem emerging at European level in PRIIPs and MiFID II.

185. To the FCA's question about whether pounds and pence information can help consumers, this is entirely possible if expressed in an appropriate manner. Consumer research indicates a

preference for such information and MiFID II will require it from distributors to reflect the total economic cost of investment, through the chain, over a given period on an ex post and ex ante basis.

186. The point we question, however, is whether the information on fund management contained within the aggregated disclosure as per Options C and D will be meaningful, given what we know about the non-linear nature of transaction costs and trading volume.

187. Part Four explores further how issues raised in the Market Study can be linked to evolving regulatory debate at EU level, notably through PRIIPS and MiFID II. Taken together, both PRIIPs and MiFID II fundamentally change the way in which charge and cost accountability will take place in future. The FCA and the UK fund management industry could usefully explore the future of cost and charge disclosure in this context, drawing on the potential for both quantitative and narrative models of the kind described above in paragraph 183.

5. Box management

188. The manager's box is a mechanism that facilitates the matching of unit transactions outside the fund itself. It can be operated as a service to investors that can buy or sell units at a better price than would otherwise be possible. It is never the case that this mechanism operates to the detriment of the performance of the fund.[79] We set out a more detailed technical description of the mechanics of box management in Annex Two.

189. According to the FCA Handbook (COLL 6.2.9 G (4)) a box can also be operated *"with the principal aim of making a profit."* We understand from firms that there may be additional information available as to regulatory expectations in bilateral supervisory contact that is not necessarily available in the form of guidance. The Final Report of the Market Study offers an opportunity to resolve this.

190. The FCA suggests a rule change such that 'risk free box profits' do not accrue to the manager and are instead diverted into the fund. We believe that the market as a whole would benefit from greater regulatory clarity in this area. However, care should be taken to respect that dual pricing is the most robust approach to protecting investors; it is the only approach that fully protects the fund from dilution whilst, at the same time, via the manager's box, facilitates the sharing of the benefits of matching unit transactions between incoming and outgoing investors.

[79] Box 7.2 (p.139) of the Interim Report suggests a different interpretation of the relationship between the box and the fund.

PART FOUR: INVESTMENT FUND DISCLOSURE AND OBJECTIVES

Summary

191. The Interim Report expresses a range of concerns about how asset managers communicate their objectives and outcomes to investors, and sets out preliminary views about the way forward. The IA agrees that clarity of objectives and accountability for outcomes is extremely important and looks forward to dialogue with the FCA about how to address the issues identified. One particular area of focus should be the scope for greater consistency of language and terminology. We link the themes raised here to the discussion on 'Value for Money' in Part Five whereby any enhanced consideration or reporting requirements on value should necessarily include consideration of delivery in the context of fund objectives.

Section 1 – Overview of Interim Report findings

192. The Interim Report focuses on comparability of past performance presentation; disclosure and performance fees in the absolute return fund sector; and the clarity of investor communication material more generally. It presents a number of options for improving disclosure and also considers how to assist investor switching from underperforming funds.

Section 2 – Regulatory requirements

193. The nature and style of the statement of investment objectives and policy in prospectuses has developed based on a dialogue between the regulator and the authorised fund manager (AFM) or, more typically, the regulator and the AFM's solicitor, who is required to certify that the prospectus conforms to the relevant rules. The regulator must provide approval.

194. Point of sale disclosure literature is thoroughly regulated at domestic and European levels. This not only covers descriptions of the investment objectives and policy but also risk, performance and costs. We would therefore encourage further consideration of how improvements can be made within the context of the broader constraints imposed.

Section 3 – Disclosure of objectives

195. A key challenge for fund managers in disclosure of objectives and performance targets is to ensure as much precision as possible while allowing a degree of manoeuvre to the portfolio manager in delivering performance. There is, however, a recognition in the industry that greater consistency of language will help investors with respect to clarity of objectives. The IA would welcome a joint project with the FCA to take this forward.

Section 4 – Disclosure of delivery against objectives

196. High standards of disclosure and comprehensive accountability are essential in ex post reporting. Where specific performance targets have been stated, reporting should take place against these. More generally, comparison of performance to appropriate benchmarks, where they are relevant and meaningful, can be a helpful disclosure instrument.

197. The issue of passive comparators, suggested by the FCA, raises an important point about the limitations of benchmark comparison and we would welcome further dialogue with the FCA about the role of comparators. Comparing a fund to a frictionless benchmark does not necessarily help investors understand the value of a fund, whether active or passive.

198. The broader issue of performance comparison with benchmarks, whether for passive or active funds, raises the fundamental question of gross v. net of fees reporting. The IA does not challenge regulatory requirements to report net of fees return in a retail market. However, to judge investment delivery in a pure form may require a different framework which might also facilitate an understanding of how different charges affect return through the distribution chain (e.g. fund management, platform, advice), starting from the gross of fees return itself.

Section 5 – Fund closures

199. Among other reasons, fund managers may propose to close or merge funds in order to protect investors. By way of merging underperforming funds with more successful vehicles, investors in the underperforming funds gain from the potentially better performance and additional scale of the new fund. Ex post disclosure in annual accounts should demonstrate whether this was successful. Mergers are approved by the FCA. We address the broader issue of regulation and closures in Part Six.

Section 6 – Performance, switching and rating providers

200. We do not believe there is any public role for regulators in 'shining a light' on poor performance, not least because UK and EU regulators have taken the view that past performance is not a reliable indicator of future performance. The appropriate role of regulators here is to establish parameters for good governance and clear reporting, and enforce accordingly.

201. Gatekeepers such as platforms and rating agencies can play a significant role in assisting investor decision-making, thereby strengthening the market demand side. Given wider evidence that gatekeepers can help investors identify well-managed funds, this issue needs further attention in the context of the switching debate and the definition of guidance vs advice.

202. The Interim Report raises the question of ratings agency business models. We recommend that the FCA examines this issue in more detail during the ongoing post implementation review of the Retail Distribution Review.

1. Overview of Interim Report findings

203. The Interim Report raises the issue of clarity of investment objectives and reporting of outcomes mainly in three areas.

- In the context of **comparability of past performance figures** and how easy it is for investors to use these. The FCA notes that this can be difficult for the following reasons:
    - Past performance as shown in UCITS KIIDs may cover different periods for each fund. This could be an issue when *"funds set up at different times … have performance measures over different time periods"* particularly if *"some funds' performance history spans volatile market events while others' do not"*.[80]
    - Funds that perform poorly are often liquidated or merged into another fund so that past performance of existing funds will not *"reflect the performance of funds that have been liquidated or merged"*.[81]
    - The use of 'readily-available and recognisable benchmarks' is commented on, in that *"it may not accurately reflect [a fund's] overall investment strategy and associated risks"*.[82]
- In the context **of targeted absolute return funds** (ARF) where it is noted that *"some ARFs do not present their performance against the relevant returns target"* and that *"a number of ARFs funds also levy performance fees on a lower performance objective than to the secondary objective held out to customers"*.[83]
- **The communication material that is available to investors** and the extent to which this allows them to understand what they can expect from the fund (in terms of objectives) and assess whether their expectations have been met (in terms of delivery). It was noted that some funds had objectives that were not specific. Moreover, for a sample of funds that had limited deviation from an index, the disclosure explaining this deviation was often confusing in the eyes of the FCA. The regulator believed that most retail investors were unlikely to appreciate that these funds were unlikely to outperform the market.[84]

204. The Interim Report discusses potential measures to help retail investors identify which fund is right for them. Options considered are:

- Additional requirements for clearer and more specific fund objectives.

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[80] Para 4.39, p.53.
[81] Para 4.40, p.53.
[82] Para 4.43, p.54.
[83] Paras 4.53-4.54, p.56.
[84] Paras 4.90-4.91. p.65. Part Two of our response (and the corresponding analysis in Annex One) provides evidence as to why we think that metrics measuring deviation from an index cannot indicate the likelihood of outperforming the market.

- A concrete timeframe over which performance should be assessed.
- Disclosure allowing investors to assess whether performance objectives are being met, including disclosing managers' benchmarks.
- Requirements to explain the performance of funds that have merged/closed.

205. The FCA recognises that more explicit objectives might be misinterpreted as guarantees by investors but believes that this tension can be managed by disclosing appropriate measures of risk alongside the objectives.

206. Furthermore, the FCA is considering options to help investors decide whether to switch away from funds that persistently underperform. Proposed remedies include regulatory exposure of funds with long-term underperformance; requirements for AFMs to be pro-active in communications or an obligation to compare performance to a relevant benchmark.

2. Current processes and industry-regulatory interaction

207. Under the authorisation process for new funds adopted since the coming into force of the original Financial Services Act in 1988 and continued through changes in regulator leading up to the FCA, the statement of investment objectives and policy set out in the fund's prospectus has been reviewed and often commented on by the regulator. For authorised funds, any changes in investment objectives or policy other than those of a minor non-material nature have also needed to be approved by the regulator. Because of this, the nature and style of the statement of investment objectives and policy in prospectuses has developed based on this dialogue between the regulator and the AFM or, more typically, the regulator and the AFM's solicitor, who is required to certify that the prospectus conforms to the relevant rules.

208. In the "Meeting Investors Expectations Review" the FCA in 2016 concluded that: *"fund management firms are taking the right steps to meet investors' expectations and comply with their responsibilities towards investors."*[85] Further in paragraph 3.2 on page 7 it reads: *"In our sample, firms generally provided adequate information about the funds' strategies, characteristics and inherent risks, enabling customers and financial advisers to make investment decisions on an informed basis."* We would welcome further clarity as to how the conclusions drawn in the market study are different from those in the focused thematic review only a short time ago.

209. We would also welcome further clarity as to the prevalence of the findings in Paras 4.90-4.92 of the Interim Report that set out key findings in the area of disclosure and clarity to investors. We understand that these are actually based on a sample of 39 funds from the Hargreaves Lansdown 150+ list (where 8 were considered to follow best practice) and a sample (of undisclosed size) of funds that showed limited deviation from an index. It would also be helpful to understand what investor communication documents, e.g. prospectus or KIID or both, have been reviewed in this respect.

[85] FCA, TR16/3, *Meeting investors' expectations*, para 1.5, p.3.

210. We explore some of the challenges in setting out and communicating objectives below, and provide suggestions about potential changes that can assist investors in understanding what the fund is designed to achieve and how the performance of the manager is to be judged against the outcome sought.

3. Objectives and performance targets

211. The main purpose of the description of investment objectives and policy is to inform investors about how a fund is being managed and to indicate what risks the fund will be exposed to. Moreover, it can be used to set explicit return targets (but not guarantees). Post sale disclosure informs investors about performance. If appropriate, relevant benchmarks can be used to illustrate relative performance.

212. The Interim Report notes that it might be difficult for investors to know what to expect from funds they are invested in and to assess whether the objective is met. It is suggested that greater consistency in the expression of the fund's objectives and reporting of delivery needs to be achieved.

213. However, in this context, it should be stressed that from 2018 new European level disclosure requirements via PRIIPs and MiFID II will start becoming applicable for funds, with the aim to address these points. Specifically, the incoming rules will require further reviewing of existing literature and lead to a more consistent disclosure environment by answering the questions ‘What are the risks and what could I get in return?’ and ‘How long should I hold it and can I take money out early?’.

Investment objectives

214. The managers of authorised funds are required to set out and publish the investment objectives and policy of the fund (see COLL 4.2.2R). The prospectus must state the investment objectives of the fund and the investment policy for achieving those objectives, including the general nature of the portfolio, any intended specialisation and an indication of any limitations on the investment policy. The wording of the rule is open to interpretation but the FCA reviews a draft prospectus prior to authorising any fund and must approve any change in investment objectives or policy.

215. The key challenge from a portfolio manager’s perspective is providing a meaningful and accurate description of the product and investment strategy while not constraining management activities that need to be flexible enough to deal with external conditions which may require significant changes in investment approach over time. It is important in this context not to confuse investment objectives and performance targets. There is no reason why a statement of investment objectives cannot include a statement concerning a performance target, but they are not the same thing.

216. The description of investment objectives and policy required in the prospectus is supplemented by other required information which may help an investor to understand how the fund will be

managed to achieve the objectives.[86] Hence, a large amount of information is available to investors about a fund's investment objectives, policy and how it will be made available to them. However, in the industry's experience, retail investors rarely look at prospectuses. Also the presentation and language used across different products is not always consistent, which might make it difficult for them to understand and compare products. Indeed, these insights led European regulators to propose the first in a series of attempts to provide retail investors with something more concise than the disclosure in the fund prospectus.

217. The first attempt to provide the most vulnerable investors with a key information disclosure document was the simplified prospectus, but this was deemed to be still too complicated and (particularly) too long to encourage investors to read it. For most funds, KIIDs have replaced simplified prospectuses since February 2012.

218. The KIID Regulation includes requirements governing the description of the investment objectives and policy of the fund, covering *"those essential features… about which an investor should be informed, even if these features do not form part of the description of objectives and investment policy in the prospectus"*.[87] The description must also provide information as to

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[86] Further required information covers:
- certain statements if the fund is intended to produce a positive return in all market conditions (i.e. a total or absolute return strategy);
- a description of permissible asset types;
- the proportion of the fund which may consist of different asset types;
- a description of transactions which may be undertaken on behalf of the fund and of techniques and instruments or borrowing powers which might be used;
- a list of the eligible markets in which the fund may invest;
- whether immovable property may be held and where;
- details of spread of investment in government and public securities;
- the extent to which the fund may invest in funds managed by the AFM or an associate;
- the policy on index replication (where applicable);
- how derivatives may be used by the fund manager and the risk implications of their use;
- information concerning the profile of the typical investor for whom the fund is designed;
- certain details if the fund is a money market fund, and;
- a volatility statement (where required).

[87] This description should include, inter alia:
- the main categories of eligible financial instruments;
- whether the fund has a particular target in relation to any industrial, geographic or other market sectors or specific classes of assets;
- whether the investment approach includes or implies a reference to a benchmark and, if so, which one, and the degree of investment freedom allowed in reference to this benchmark (including whether the fund is designed to track the index);
- where the fund invests in debt securities, an indication of whether they are issued by corporate bodies, governments or other entities and any minimum rating requirements;
- whether the fund is a structured product and details of the "pay-off", including references to any algorithm described in the prospectus;
- where the choice of assets is guided by specific criteria, an explanation of those criteria, such as "growth, value or high dividends";
- where specific asset management techniques are used, such as hedging, arbitrage or leverage, an explanation of the factors that are expected to determine performance;
- where the impact of portfolio transaction costs is likely to be material, a statement that this is the case;
- any minimum recommended holding period, and;

whether the investment approach includes or implies a reference to a benchmark and, if so, which one, and the degree of investment freedom allowed in reference to this benchmark (including whether the fund is designed to track the index). As with prospectuses, the FCA requires a copy of the KIID in draft form before authorising a new fund, which its officials review and make comments on.

219. Finally, the AFM must prepare a long report for each annual and half-yearly accounting period (COLL 4.5). Each report must include: the policy and strategy pursued for achieving the investment objectives of the fund; a review of the investment activities during the period; and a portfolio statement prepared in accordance with the SORP.

220. In conclusion, the FCA has been approving what is disclosed, with a high degree of specification about pre-sales disclosure already set in regulation. Enhancements in this area will therefore need to take place in the context of these constraints. As we discuss further below, the IA suggests that more could be done by the industry, in partnership with regulators, to look at the question of consistency of language in order to provide investors with greater clarity and comparability when looking at the objectives of different funds.

Performance target

221. From Chapter 4 of the Interim Report, we understand that one concern is that not enough funds set out a specific performance target in their investment objectives or a recommended time period over which to judge performance against that target.

222. For some strategies, particularly outcome-focused funds, a specific, stated performance target may be entirely appropriate. However, across the wider fund universe, this will not always be the case. There is also a degree of concern from some managers about how targets may be judged by investors whose unit-holding is unlikely to coincide with standardised performance reporting periods (such as the above mentioned UCITS KIID standard).

223. There is no doubt that investors and their advisers use various tools to assess the performance of funds and that performance can be assessed in a number of ways:

- in absolute terms;
- against the performance of a peer group (such as other funds in the relevant IA funds sector);
- against a relevant benchmark or combination of indices; or
- against the return available from a bank or building society.

224. These tools are widely available and widely used. With regard to the time period over which investors should judge fund performance, the industry has consistently promoted retail funds

- any other information necessary to adequately describe the investment objectives and policy of the fund.

as long-term investments. This does not stop distributors and commentators from concentrating on shorter term performance metrics, despite the 10 year performance history shown in KIIDs.

225. Finally, it should be noted that neither MiFID II nor PRIIPs will require the definition of performance targets. Any possible regulatory intervention would need to ensure that it does not create regulatory barriers to different disclosure and carefully consider their impact on cross border marketing from UK vehicles into the EU and vice versa.

Use of benchmarks

226. On the question of whether the FCA should set out expectations on using benchmarks, particularly when benchmarks are used to trigger performance fees, more clarity would be helpful. We note the concerns expressed in the Interim Report in relation to performance information quoted in respect of ARFs and particularly in relation to performance fees. The IA would be interested in understanding the prevalence of these concerns and in discussing this area in more detail with the FCA.

227. The FCA's Thematic Review on Meeting Investor Expectations (TR16/3) identified some funds which were following a benchmark constrained strategy but had not disclosed this in their key investor information documents. TR16/3 stated that *"if a fund is structurally constrained by policy or practice this should be disclosed to investors",* and that *"funds with benchmark-related strategies must disclose the benchmark and, for active funds, the degree of freedom which the manager has relative to the benchmark"*.

228. Fund's benchmarks are not the same as the fund's objectives. At the same time, different benchmarks could be proposed for comparison for any given product. The IA would be interested in a discussion around different types of benchmarks and the usefulness of benchmarks such as cash, single market traditional benchmark (e.g. FTSE) or composite benchmarks that might be very specific. However, setting the investment objective is part of the value of active managers. In some cases this means there simply can be no meaningful comparison to a benchmark.

229. One relevant issue in the debate around benchmarks is the costs of access to them. The EU Benchmark Regulation aims to improve the functioning and governance of benchmarks and to ensure that benchmarks produced and used in the EU are robust, reliably representative and fit for purpose.[88] Also, it requires any benchmark used to be disclosed in the prospectus. If the expectation is that firms must use a benchmark in their literature that is subject to comparable constraints (i.e. consists of similar components to the fund) it might have to be specifically tailored or be a combination of several benchmarks.[89] Even if on first sight this might be most appropriate for a product, the benchmark(s) are unlikely to be publically and freely available. Only if investors and advisers have access to the benchmark(s) can they benefit from its use.

[88] See Regulation (EU) 2016/1011 at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32016R1011.
[89] The Benchmark Regulation does not prescribe compulsory use of benchmarks.

However, costs for more specific benchmarks are high and rising. Therefore, if compulsory, a market standard that guarantees free accessibility should be sought.

230. Using an appropriate passive comparator might help address the issue of what a given active fund has delivered against a commercial provider of benchmark returns. However, this will likely be easier in the area of asset class components (e.g. a given equity market) than funds with more complex objectives. Additionally, using a benchmark may be preferable given its external transparency and consistency. Again, further dialogue in this area would be valuable.

231. Finally, if the use of a specific benchmark constrains the AFM in its investment decisions when reacting to market developments, this might be detrimental to performance and therefore not in the best interest of the investors.

Enhancing clarity on objectives and targets

232. The IA agrees that, within the constraints of regulated performance presentation, investment objectives and targeted outcomes should be described as precisely as possible.

233. The Interim Report focuses in particular on absolute return funds (ARFs), but at a more general level, we note the growing prevalence of outcome-focused funds. These may be measured against different benchmarks from one another, managed to different timeframes and present different risk characteristics. In order to facilitate consumer information and create a common framework for accessing ARFs, the IA Targeted Absolute Return Sector definition requires an objective – and carries performance histories – over a certain timeframe. A data tool in the IA site allows investors to see clearly the objective and timeframe, and to filter funds with similar characteristics.

234. From the IA perspective, a standard for common language would be very helpful. For example, where an objective is expressed as long term, what is meant by long term? Or where volatility is relevant to an investment objective, to what extent is a common methodology being used? While there are inevitably limitations as to how far a common lexicon can be developed, we would be very interested in a joint piece of work with the FCA to further develop consistent descriptions, free of jargon, that facilitate the further development of objectives as presented by product manufacturers.

235. Finally, as with all recommendations concerning investment funds, there is a need to acknowledge EU requirements and to ensure that all potential remedies are compatible with a cross-border and wider international funds environment.

236. The incoming PRIIPs Regulation will require all PRIIPs (not just funds) to include in their KIDs performance scenarios and an indication of the recommended holding period. In this context, we take the view that European legislation has already made a significant contribution to addressing the FCA's concerns in this area. The difficult part will be to work out how to combine the FCA's desire for a more specific performance target for each fund with the PRIIPs Regulation's performance scenarios, which may be more formulaic. This is an area where the IA would be very happy to work with the FCA to develop a solution.

237. If a new standard could be introduced, it would have to be made clear that it referred to normal market conditions[90] and should not prevent managers acting in the best interest of clients in extreme situations. The work should review how all clients, whether direct or indirect, advised or not, have access to the information in the format they can best absorb.

4. Ex post reporting on delivery

238. The AFM annual and half-yearly report must include a review of the investment activities during the period, and a portfolio statement prepared in accordance with the SORP. The information included in this document is there to assist investors to make an informed judgement about the activities of the fund manager over the period and their contribution to meeting the fund's objectives.

239. Few retail investors look at long reports, but it is easy for them or their advisers to access performance information and to compare this against a benchmark of their choice. As the Interim Report makes clear, out of the 22% of retail business that is non-advised, the majority is held through platforms, which typically provide their customers with tools to make such comparisons.

240. Tools for performance comparisons are already widely available and continue to be developed for use by advisers, platforms and end clients. In the absence of any evidence to the contrary, it seems unlikely that a lack of information about fund performance is damaging competition in the sector. On the contrary, the evidence from net fund sales over many years seems to indicate that performance is absolutely central to competition between AFMs.

241. In regards to the Interim Report concern about comparability of part performance information, we would point that, the UCITS KIID (although a point of sale document) illustrates past performance in a mandated format. A bar chart shows the performance in discrete years to 31 December in each year for the past ten years (or for each year for which there is a full year's performance data since launch of the fund if less than 10 years) calculated on the same basis – net of charges and with income reinvested. As such, performance in the KIID is comparable across funds for each full calendar year for which the funds have been in existence.

242. Regarding the Interim Report findings that in the absolute return sector, where there is greater use of specific performance targets, such as cash plus X%, it would be helpful to get more clarity as to how prevalent this is amongst ARFs. Nonetheless, it is reasonable that there would be more precise reporting of delivery against those over appropriate timeframes. The IA agrees that investors should be able to access information looking at actual performance vs targeted performance for any fund where such specific targets are used in published objectives. We would welcome dialogue with the FCA about how that could best be delivered.

243. The FCA also asks whether there is a greater role for passive comparators. We assume that this would be focused on single asset 'component' funds, given that asset allocation and outcome-focused funds are by definition active management and it is difficult to envisage appropriate

[90] Although what would constitute 'normal' market conditions would also have to be defined.

passive comparators in this context. Even so, comparison of single asset class funds with common benchmarks is not always possible. Investment objectives of the active fund may not align with the composition of existing benchmarks.

244. This raises a fundamental point about the challenges of benchmark comparison. While a peer group measure has limitations, it is in principle a like-for-like comparison of individual fund net return against average fund net return. Comparing a fund to a benchmark that cannot be accessed without cost does not necessarily help investors understand the fundamental value added of an investment fund, either active or passive. As we point out in Part Two, this is particularly the case with bundled share classes that also contain advice and distribution fees.

5. Fund closures[91]

245. We acknowledge that the FCA plans to do further work between the Interim and Final Reports to explore what happens to merged funds. In practice, retail funds that underperform over a long period tend to lose assets. While the decision to terminate a fund can have a significant impact on investors, fund mergers or closures often take such underperformers out of the picture and focus on what would be in the best interest of the investors. As discussed in Part Two, this is exactly what we would expect to see in a competitive market.

246. In section 10.25 the FCA considers requiring managers to explain the performance of funds that have merged/closed. We would like to point out that this is contrary to regulatory requirements. Merged funds may not use the performance history of the previous entities in their UCITS KIID performance illustrations. To require fund managers to do something else (via other literature) will lead to an inconsistent presentation of the same product. The UCITS directive specifically prohibits the use of information that contradicts information given in the UCITS KIID.

247. The IA would like to work with the FCA on any further research in this area to gather data on how the market responds to persistent underperformance. We could also assist in any further work looking at terminations and mergers such as further standardised practices and note that this area is already subject to investigation by IOSCO in the form of its Consultation on Good Practices for the Termination of Investment Funds (CR04/2016).

6. Performance, switching and ratings

248. The Interim Report raised the question of whether the FCA should 'shine a light' on poorly performing funds. Given the FCA's stance that past performance is not a guide to future performance,[92] we think it would be difficult for the FCA to explain why it was highlighting certain funds because they had historical poor performance. Circumstances might change (such as the appointment of a new portfolio manager) and the fund might be top quartile in the next period. Such scenarios are far from infrequent. Investors who had sold funds because of the

[91] Also see Part Six of this response for further comments regarding mergers and closures of funds.
[92] See COBS 4.6.2(4).

'shining light' might be disadvantaged by acting on the information provided by the regulator.[93] The regulator does of course have the important task of reviewing the literature of funds in the authorisation process and needs to step-in in case of mis-selling, as well as setting the parameters of disclosure and governance.

249. The discussion of the role of past performance, and the potential role of the regulator, raises an important point about how investors can get information to inform their purchasing behaviour, whether investing new money or switching from existing funds. The regulatory direction of travel in Europe is moving away from displaying past performance at point of sale as the EU moves from the KIID to the new KID.[94] We disagree with this direction of travel for reasons set out below.

250. One major advantage of the PRIIPs project is the ambition to enable investors to make comparisons across different investment products, not just between different authorised funds. However, as the Regulation and draft implementing rules currently stand, the first iteration of the Key Investor Document will not be able to deliver on this. The presentation methodologies used in the performance and costs sections, based on holding and performance assumptions, render comparison impossible. Ideally, the KID would show past performance (complemented by future scenarios as per legislative requirements) which would illustrate the quality of the professional responsible for investment decision-making. The costs section would have to provide information on the actual costs paid by the unitholder, not a hypothetical 'Reduction in Yield' figure that blurs information about ongoing, entry, and exit costs with performance expectations.

251. This wider European debate on disclosure needs to be considered and any recommendations framed accordingly. The new KID will list the objectives and the means for achieving them: a risk-reward profile of the product, minimum recommended holding period, possibility of disinvestment (including penalties), consequences of cashing in and a brief indication of any additional information documents to be provided to the investor.[95] The new KID seems to us to directly address a number of the questions raised in the Interim Report related to metrics that could be helpful to investors about likely future returns. The major shortcoming remains the presentation of costs and performance scenarios.

252. This in turn raises the question as to how others in the chain, notably gatekeepers such as platforms and rating agencies may be able to assist investors. The FCA makes specific reference to the role of fund ratings in retail distribution of investment funds. Ratings as well as best buy/short lists are an important tool for distributors, helping them to find the best available products for their clients and to highlight those funds to their clients. In the context of FCA

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[93] See Part Five of the response for a discussion of the concept of 'value for money'.

[94] Although a point of sale document, required by the UCITS directive, the KIID also illustrates past performance in a mandated format. A bar chart shows the performance during the past ten years (or since launch of the fund if less than 10 years). KIIDs are reviewed at least annually and generally updated in the first quarter of the year. KIIDs for different products will always show the performance of the past decade and therefore be comparable. The PRIIP KID will replace the UCITS KID from 2018 onwards.

[95] See Article 8 of the PRIIPs regulation.

concerns about clarity of disclosure, such third party analysis is also an important external source of scrutiny of objectives and delivery against those objectives. This can bring significant competition benefit to the extent that it facilitates a better informed demand side. We describe the role of gatekeepers in more detail in Annex One.

253. While past performance is indeed not a reliable indicator of future returns in uncertain markets, Interim Report evidence[96] and an external study on gatekeeper recommendations[97] suggest two conclusions: first, that manager/fund track record and investment process matters and second, that external parties are already able to shine a light on this for investors.

254. In this regard, we would argue that the main objective of gatekeeper analysis is not just to help investors *"identify outperforming funds and asset managers"*.[98] Third party ratings consider a wide range of factors and are not narrowly focused on performance. A fund can get a good rating for having a strong management or operations and it is not a guarantee that this fund will outperform or has consistently outperformed in the past. Moreover, third party ratings are different in nature from best buy lists in that the latter are recommendations of funds to buy, and as such change to reflect current or expected market conditions, whereas ratings are more constant and take a view of the best funds for a particular strategy while not being a recommendation that the strategy is appropriate at all times. For example, a Smaller Companies fund may have a consistently high rating, but this does not indicate that investors should consistently have an allocation to small caps.

255. The issue is a significant one because it also raises the question of the role of guidance to retail investors, and the boundaries between guidance and regulated advice: for example, an intermediary may feel that an investor would benefit from moving funds, but is not offering regulated advice to that investor. Changes currently being considered as part of the Financial Advice Market Review may help to clarify the boundaries in this area. It seems to us that the questions posed by the FCA about switching involve some challenging discussions both about the nature of past performance and the role of guidance in the retail market. We would be keen to engage further in these areas.

Role of third party ratings providers

256. The Interim Report raises the issue of third party ratings providers business models and asks for stakeholder views.[99] As mentioned, third party ratings providers perform an important role in fund selection for advisers and direct investors. It is difficult to measure the influence third

[96] See the econometric analysis in Annex 4, pages 13-19, which finds that recommended funds on platform best-buy lists significantly outperform non-recommended funds and that share classes rated with 5 stars by in Morningstar significantly outperform other share classes. The analysis suggests that rated and recommended funds do not significantly outperform the benchmark. However, these results are based on bundled charges as the returns of all clean share classes in the sample were adjusted to reflect costs of management and distribution. In the context of further FCA work in this area (Annex 4, para 80, page 19) and as per our discussion in Part Two, we would welcome further analysis on a clean basis, i.e. where all returns are adjusted to reflect management costs only.
[97] Fundscape and GBi2, *The Gatekeepers Report: Unlocking the Secrets of Fund Research*, 2016.
[98] Para 4.26, p.49.
[99] Para 5.47, p.88.

party ratings have, although, anecdotally, fund marketing and sales professionals consider them important.

257. We outline below three different business models for third party ratings providers:

- The <u>pay-to-play model</u> works on the basis that the fund group seeking the rating pays the service provider upfront. The fund will have to pass some initial tests, perhaps quantitative based or some basic qualitative tests such as whether the portfolio manager has been in situ for more than 12 months. The agency will carry out the analysis and issue the rating. The fund group is then able to use the rating in its marketing material. Service providers might also use paid for ratings in software offered to distributors to help with fund selection.

- The <u>licencing model</u> is where the rating agency will carry out the analysis on its own initiative and issue the rating. Fund groups will then be approached to pay for a licence to use the rating in their marketing material. Different levels of pricing based on number of funds rated is sometimes a feature of this model.

- The <u>user of the rating pays</u> for it. That could either be a third party provider offering a 'fund picking service' to for example IFAs or distributors themselves.

258. In both the pay-to-play and licencing models, asset managers are paying for the research costs of distributors and advisors.[100]

259. A situation arises with (third party) software used by distributors to create fund model portfolios for their clients. In some cases only rated products are considered by the rating provider for their model portfolios. Asset managers have to pay providers to have their products listed in the software if they want to generate investment into their funds. This is also true for third party ratings providers operating model portfolio and advisory businesses, where only rated funds will be considered for investment.

260. We recommend that these business models are examined in more detail during the ongoing post implementation review of the RDR, in order to address the question of whether the remuneration process between fund managers and third party providers creates conflicts and compromises independence.

[100] See https://www.fca.org.uk/news/news-stories/post-implementation-review-retail-distribution-review.

PART FIVE: INVESTMENT FUND GOVERNANCE

Summary

261. The IA supports the highest standards of fund governance. As a way to ensure that customers can access products that they judge to be good value for money, we set out how greater clarity of objectives and of fees and costs, can be brought together with new product governance requirements in the context of the duty of care to unitholders. We also consider how the exercise of that duty can be best subjected to effective challenge. The answer is likely to lie with a proportionate approach, drawing on European fund governance models, rather than importing models from other parts of industry, domestically or internationally.

Section 1 – Overview of Interim Report findings

262. The Interim Report explores the extension of existing duties of care (best interests' obligations) so as to include a value for money (VfM) test, noting that this is not currently explicitly required. The FCA proposes a specific new requirement in this area and communicates a degree of scepticism that this can be discharged under existing fund governance arrangements due to broader concerns about the management of conflicts of interest.

Section 2 – European fund governance regulation

263. Duty of care requirements to act in the best interest of investors are part of the European regulatory framework both for funds and asset managers. We suggest that more prominence should be given in the Interim Report to the potential role of the detailed product governance framework now codified under MiFID II and being specifically applied to UK authorised funds under FCA proposals. New target market requirements, combined with explicit consideration of the impact of costs, mark a significant change.

Section 3 – Definition of Value For Money

264. Value is subjective and ultimately a utility judgement by users of a service, not those providing it. However, we agree with the Interim Report that there is much that providers can do to ensure that customers will access good value products. The recent focus by European legislators on product governance requirements under MiFID II is a significant step forward.

265. We are cautious about borrowing VfM as a regulatory concept from the DC workplace pensions market, where the OFT found an extremely weak demand side. There are fundamental differences between DC workplace pensions and the asset management market, primarily a much stronger set of intermediaries between industry and customer.

266. We suggest an alternative approach to VfM, based on enhanced disclosure and enhanced product governance, both expressed in the context of a duty of care to act in the best interests of unitholders. This moves the value discussion beyond a primary focus on cost and also into a place where consumers and their representatives are better able to assess value.

Section 4 – Ensuring Effective Challenge

267. Effective challenge is an important element of good governance. We do not offer a firm view on preferred remedy at this stage, but consider there is need for a clear debate about what the ultimate objectives are and how they can be achieved in a proportionate manner. While independent directors can help to achieve good governance, there is limited evidence internationally that they act as a driver of competition.

268. We emphasise the importance of SMCR, which creates a whole new level of requirements regarding senior management responsibility and accountability that are likely to extend to AFM Board members. Option C (introducing independent directors) will in effect see a combination of a redefinition of duty of care, the introduction of SMCR and a fundamental change in AFM board governance. This may be premature in light of our comments on the evidence base, and potential complexity of implementation.

269. Finally, we support the FCA's caution on a broader fiduciary duty. Given the existing best interests rule and provisions on conflicts, we do not understand what this would add in practice. Not only does this potentially cut across existing detailed duties of care under UCITS and MiFID, but it seems ill-adapted to the specific problems that the proposed remedies intend to address.

1. Overview of Interim Report findings

270. The Interim Report finds that that there is a failure robustly to consider value for money (5.48-5.54), but notes that *"AFM boards…do not currently have an explicit and well defined obligation to seek value for money"* (10.9). It is not therefore entirely clear whether the problem relates to an obligation that does not exist (which it would perhaps be unreasonable to see as a failing) or whether the FCA believes that firms are poorly discharging aspects of existing regulation regarding their duty of care.

271. The remedies points more towards the former with the Report considering how to introduce a *"a strengthened duty on asset managers to act in the best interests of investors, including reforms that will hold asset managers accountable for how they deliver value for money, and introduce independence on fund oversight committees"*. In the governance remedies, we infer from 10.10 that the FCA is particularly concerned to address its finding of weak price competition, lack of tiering and break points; better control of transaction costs; and box profits.

272. The Interim Report implies that there are inherent weaknesses in current fund governance structures that mean that both existing duties and a new 'value for money' duty might not be effectively discharged without inherent conflicts of interest.

2. Existing regulation of European governance

273. There are already clear requirements in both UCITS and MiFID to act honestly, fairly and professionally, in the best interests of clients and to have conflict management. This point in

particular was picked up by the Financial Services Consumer Panel in its 2015 report on duty of care across financial services more broadly.[101] As we explore further below, there are also significant new requirements regarding product governance. There needs to be greater acknowledgement of this, which could help facilitate a discussion as to how these new requirements, which include a consideration of charges, can be integrated into the current competition discussion. We set out below how existing and forthcoming requirements provide an important framework for the value for money discussion.

Existing duty of care

274. The implementation of UCITS IV in the UK has introduced from 1 July 2011 the requirement to act with high levels of duty. Coll 6.6A 2R(6) states that an AFM must, in carrying out its functions, *"act honestly, fairly, professionally and independently; and solely in the interests of the UCITS scheme and its unit holders"*.

275. MiFID and MiFID II impose equivalent obligations on investment managers, as there is already a duty of care embedded in the Level 1 text. We note in particular Article 24 (1) of MiFID II, which states that: *"Member States shall require that, when providing investment services or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients."*

276. This theme is then further developed throughout Article 24, and specifically in respect of fees to ensure that any payment (or benefit): *"does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interests of its clients"*[102]. This is why, despite the already existing TCF principle, the UK had to expand the expression of duties from November 2007 by including the first iteration of what is now COBS 2.1.1(1) in the current FCA Rulebook - A firm must act honestly, fairly and professionally in accordance with the best interests of its client (the client's best interests rule).

MiFID II fund governance arrangements

277. The Interim Report has signalled the need to take account of forthcoming regulatory developments, including MiFID II, which will apply from 3 January 2018. This is important in the context of governance remedies since MiFID II brings in much stricter and more detailed product governance requirements, the purpose of which is to ensure, amongst other things, that products are manufactured to meet the needs of an identified target market and that the performance of the products offered are periodically reviewed.[103]

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[101] Financial Services Consumer Panel, Incorporating a Duty of Care into the Financial Services & Markets Act, June 2015. The Panel did not propose a "full fiduciary duty" should govern the relationship between a firm and its customers. Rather it proposes a defined duty of care on the firm: "to act with reasonable care towards the customer to ensure that the customer does not suffer unreasonable harm or loss". While the Panel did not feel existing FCA requirements to treat customers fairly had sufficient statutory backing, the Panel did refer to areas of European law where duties existed. The Panel concluded: "These Directives provide a legal principle governing relationships between firms and their customers for firms providing **asset management** [our emphasis], mortgages and insurance mediation, irrespective of any further action at UK level."

[102] MiFID Article 24(9)(b).

[103] MiFiD II Recital 71

278. The product governance provisions can be regarded as an expansion and elaboration of the existing duty of care in European governance structures. As mentioned above, Article 24(1) sets out the duty of care and, at a high level, what this means in the context of the manufacture of products: "*Investment firms which manufacture financial instruments for sale to clients shall ensure that those financial instruments are designed to meet the needs of an identified target market of end clients within the relevant category of clients, the strategy for distribution of the financial instruments is compatible with the identified target market, and the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the identified target market.*"

279. MiFID II places significant new regulatory obligations upon the management body of a MiFID firm. In relation to product governance, the management body is required to define, approve and oversee a policy as to services, activities, products and operations offered or provided, in accordance with the risk tolerance of the firm and the characteristics and needs of the clients to whom they will be offered or provided, including carrying out stress testing, where appropriate.[104]

280. The Directive requires the management body of an investment firm to have effective control over the firm's product governance process.[105] It also requires investment firms to establish, implement and maintain decision making procedures and an organizational structure which clearly, and in a documented manner, specifies reporting lines and allocates functions and responsibilities as part of the general organisational requirements.[106]

281. In addition, the management body is required to monitor and periodically assess the adequacy and implementation of the firm's strategic objectives in the provision of investment services and activities and ancillary services, the effectiveness and the adequacy of the investment firm's governance arrangements and the adequacy of policies relating to the provision of services to clients and take appropriate steps to address any deficiencies.[107]

282. Management bodies of MiFID firms may take a variety of approaches to implementing these requirements, depending upon their nature, size and complexity. They may, for example and depending upon nature, scale and complexity of their business, have a team of people, often called a product governance committee which oversees the development of products. It is important to note that, whilst a management body may delegate tasks, it remains ultimately responsible for overseeing compliance with its firm's regulatory obligations.

283. We provide, in Annex Four, a diagram, by way of example, of what a firm's product governance process might look like, taking into account the new MiFID II requirements.

[104] MiFID II Article 9(3)(b)
[105] Commission Delegated Directive 7.4.2016 Article 9(6)
[106] Commission Delegated Regulation of 25.4.2016 Article 21(1)(a)
[107] MiFID II Article 9(3) sub para (3)

Consideration of charges and costs

284. Importantly, MiFID II product governance requirements also include obligations in relation to costs and charges. In this regard MiFID II contains explicit provisions that require product manufacturers to consider the charging structure proposed for a financial instrument, including the following elements:

 a. The financial instrument's costs and charges are compatible with the needs, objectives and characteristics of the target market;

 b. The charges do not undermine the financial instrument's return expectations, such as where the costs or charges equal, exceed or remove almost all of the expected advantages linked to a financial instrument; and

 c. The charging structure of the financial instrument is appropriately transparent for the target market, such as that it does not disguise charges or is too complex to understand.[108]

285. In the UK, there already exists FCA regulatory guidance covering the responsibilities of product providers and distributors.[109] However, the above requirements go further than the existing guidance in respect to price considerations.

Application to AIF managers

286. Whilst MiFID II does not apply to UCITS and AIF managers, the FCA is consulting on proposals[110] which will apply the MiFID II product governance requirements to non MiFID firms (such as UCITS and AIF managers as well as other product providers) as regulatory guidance. The IA supports these proposals.

287. If the FCA proceeds with this proposal it would mean that in the UK, the governing bodies of UCITS and AIF managers will be subject to new product governance requirements (albeit expressed as regulatory guidance) which would include obligations as regards costs and charges. As mentioned above, whilst a governing body of a UCITS or AIF may delegate tasks (for example, to a product governance committee), it remains ultimately responsible for overseeing compliance with its firm's regulatory obligations.

288. We recognise that some of the specific concerns expressed[111] are not directly brought out in the MiFID II requirements. However, in the light of the above and given the definition of value below (which picks up the broader concept of delivering according to client needs as expressed in the product governance requirements) a discussion about potential changes to fund governance arrangements must take into account the MiFID II changes and their application to authorised funds by the FCA.

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108 Commission Delegated Directive 7.4.2016 Article 9(12).
109 FCA Regulatory Guide – The Responsibilities of Product Providers and Distributors for the Fair treatment of Customers.
110 Ch 13, FCA CP 16/29.
111 Para 5.50, p.88.

3. Defining Value for Money

289. A true assessment of value for money (VfM) will necessarily be both subjective and ultimately subject to a utility judgement by users of a service, not those providing it. For that reason, when seeking to address the control at the supplier level of those factors that will affect the inputs on which consumers will make VfM judgements, a simply stated VfM duty is inadequate.

290. The way forward in our view is to focus upon product governance in the context of a duty to act in the best interests of unitholders and the specific fund objectives. We believe this is consistent with the view taken by European legislators in forming the precise articulation of product governance requirements under MiFID II. The emphasis on how products meet the needs of the target market, including in the level and transparency of fees, appears to strike an appropriate balance between what is within the control of the manufacturer and what is not. The legislation also contains indicative examples of what is appropriate (as outlined in Para 284 above). Within MiFID II, the supply side is not therefore put in the unusual, and impracticable, position of being asked to form an absolute value judgement that would normally lie with the demand side.

291. This is particularly the case given the contrast between the fund management market and the market in which regulatory VfM requirements originates: DC workplace pensions. In the case of the latter, the OFT reached the conclusion that demand side weakness existed, partly because employees relied on employers to make decisions who *"lack the capability and/or the incentive"* in monitoring schemes.[112] Two further relevant justifications were the lack of a single decision-maker creating the scope for misaligned incentives and the exceptionally long savings period (in an inherently illiquid vehicle given lack of access to savings ahead of age 55) before which a judgement could be made.

292. Asset management is a very different proposition to DC workplace pensions, not least because in both the institutional and retail markets there exists a very strong intermediary, or gatekeeper, function, which acts to strengthen the demand side. Another significant difference relates to the level at which the choice is made: where in DC workplace pensions this happens at the employer level, whereas for funds the choice is made by the investor directly or the intermediaries acting directly on behalf of the investor. In this regard, more clarity would be needed as to why the fund market is similar to DC pension delivery, particularly given the evidence from Part One of this IA response about what standard metrics of competition are currently indicating.

Value as more than cost

293. Should the FCA decide that a specific new VfM requirement is needed, we emphasise the need to look beyond cost. The detailed criteria in the Interim Report focus uniquely on VfM as defined by cost (10.10), as opposed to broader consideration of how a fund is delivering on behalf of investors. A central argument of our submission to the FCA that there is an

[112] OFT, *Defined contribution workplace pension market study*, 2013, p.14.

opportunity to link proposed remedies, such as greater clarity of objectives and reporting against objectives, to the duty of care / VfM discussion. We believe this may be the FCA direction of travel given consumer findings on value and the FCA's statement in paras 1.33-1.34. We also believe that it is the intention behind the MiFID II product governance requirements.

294. This view also stems from our observation of two practical lessons regarding the experience to date from the DC workplace pensions market:

- There is no clear consensus – or guidance in regulation – of precisely what VfM means. While individual IGCs have been addressing the definitional issue in their first wave of annual reports, this lack of definition was originally a source of frustration,[113] and if a VfM remedy is to be applied the FCA is right to examine the question in more precise terms.

- IGC annual reports have two common features. First, cost is, quite correctly, a central criterion of VfM. Second, that cost sits alongside other features, such as performance, communications, service and administration – as per the FCA findings (para 4.5). VfM in DC pension schemes is focused at product level involving a range of factors in the process of reaching the end savers (i.e. an individual pension account, including asset allocation, investment performance, administration, governance and communication).

295. If a VfM requirement is to be brought in then it will be important that the industry and the regulator work together to ensure that operable, consistent and product-appropriate processes develop to ensure compatibility with existing regulatory evolution as well as new measures that emerge from the Market Study.

296. The experience of the IGCs and the broader international governance debates point, in our view, to a simple initial conclusion. If the FCA's central justification for creating a new duty is primarily oversight of fund fees and associated costs (articulated in the definition on 10.10), this needs to be stated and redefined as such, and no longer expressed as 'value for money' since a narrow focus on fees would be a truncated expression of VfM.

297. We believe that the most successful outcomes for consumers will be achieved in the context of joining together:

1. <u>Enhanced disclosure.</u> Clear expression, where needed, of fund objectives and delivery against objectives alongside consistent expression of charges and costs.

2. <u>Enhanced product governance.</u> Explicit consideration of the needs of the target market and the appropriateness of the charges and costs in that context.

3. <u>Duty of Care.</u> Consideration of the points above in the context of the duty to act in the best interest of unitholders.

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[113] See for example, Pitman Trustees Limited, *Where are we on defining "value for money" or good value in DC pensions: A Summary of progress*, December 2014.

298. This approach might then be seen as a further enhancement of TCF processes within the context of the best interests rule. This TCF+ approach could borrow from some of the IGC experience in an articulation of value that allows quality of outcome and quality of service to be considered, while recognising that the workplace pension IGCs oversee a product whose nature and connection to the end saver are very different from that of a fund.

299. In addition, the introduction of the SMCR to asset managers will only serve to reinforce individual responsibilities and so ensure that there are clear management commitments to deliver against these enhanced obligations.

Transaction cost oversight

300. The question of transaction cost oversight (see paragraphs 161-164) also requires further elaboration in the context of existing regulation and industry delivery structures. We would suggest that at the level of fund governance, there will be consideration of transaction costs in the context of fund turnover and performance, and associated reporting. The underlying concern within the Interim Report about transaction cost control that we understand to relate to supervisory findings on portfolio manager behaviour (7.61-7.65) would be best addressed through supervision of the best execution rules that are already in place (i.e. MiFID firms investment activity). With respect to use of dealing commission, we believe again that this is an issue that MiFID II will serve to resolve.

301. The proposed governance duty with respect specifically to transaction cost control appears to be one of challenge to the underlying asset manager (investment adviser) by the fund board. This should be spelt out. Where (as is common) investment management has been delegated to a separate investment management (MiFID) company, the fund board's knowledge of any particular trades is necessarily ex post. Additionally, fund boards might not meet frequently enough to exercise sufficiently the level of oversight that the FCA's comments appear to suggest. Data both on transaction costs and turnover rates should form part of the new disclosure settlement at fund reporting level which will be of help for investors – as such it is unclear why further remedies are required in this area.

4. Ensuring effective challenge

302. Whatever form the precise articulation of future responsibilities takes, the IA believes that effective challenge is an important part of good governance. As the FCA notes in its range of proposed remedies, this challenge can take a number of forms. We do not at this stage express a preference for a precise model. This is for the following reasons:

a. International experience suggests that the competition dynamics of concern to the FCA are not significantly affected by the existence of independent directors and/or fund boards (see in particular Paras 308-314 below), although we recognise the value that such directors may bring in broader oversight. We would welcome further discussion of the drivers of market dynamics, including those factors outlined in Part One of our response, as part of the Final Report.

b. There are a number of ways of ensuring that effective challenge emerges, including the use of independent expertise in different forms.

c. There is a need to ensure that governance remedies can achieve their objectives while ensuring that barriers to entry do not rise. For smaller firms that are a key part of a diverse, competitive market, some elements of the proposed remedies may be disproportionate and potentially costly.

d. Some of the legal structures used for the delivery of investment fund products in the United Kingdom do not easily accommodate independent directors at fund level. Given this, the IA has started to consider how this might work in practice if the regulator determines that a structural change is needed – see Annex Three for further discussion.[114]

303. However, we suggest that going forward the discussion could narrow to Options A-C, in effect within the context of European fund governance structures and experience. We set out why this is below, and then return to the issue of how independent oversight may be delivered:

a. Option A (Keep existing governance structure but clarify duties). It will be necessary at the very least for the wider fund management community to have clarity as to the FCA's new expectations in this area, given the supervisory desire expressed in Paras 5.48-50 to see the VfM duty expressed with more precision. This would appear to be the intent behind Option A.

b. Option B (Strengthen the requirements on senior managers of the AFM). SMCR is one of the most fundamental changes to affect the asset management industry in many years, notwithstanding the existence of the controlled functions regime. It creates a whole new level of requirements regarding senior management responsibility and accountability that are likely to extend to AFM Board members. Some form of relationship between SMCR and a new duty may therefore be inevitable. In our view, neither an analysis of fund manager duties of care, nor the design of a proportionate and effective set of remedies can be undertaken without considering the increased personal responsibilities and accountabilities of senior managers. We would welcome greater clarity as to why the FCA believes that a new duty of care could not be discharged – and enforced against – under existing legal structures and increased accountability under SMCR.

c. Option C (Change composition of governance bodies to create more independence). This will simultaneously combine a new duty, the introduction of SMCR and a fundamental change in AFM board governance. Given challenges to the evidence presented, both about the nature

[114] Presently two very different legal structures are commonly used for UK authorised funds, along with a smaller number of ACS. Whilst OEICs can already have independent directors, alongside the mandatory ACD, it is hard to envisage how a unit trust could have independent directors or what a Board would be if not an AFM. Even with OEICs the present role of an independent director is closely circumscribed to ensuring the regulated ACD carries out its duties.

of competitive forces in the market and the definitional clarity of VfM, Option C appears premature at this stage. It may also be complex in implementation terms.

304. Despite these concerns about Option C, it should be emphasised that the IA supports the principle of good fund governance, as do our member firms. As a matter of general principle, this should include a discussion about the role of independent oversight, where proportionality may determine to what extent elements of this can be provided by functionally independent internal oversight or by independent directors.

305. The essence of the challenge from this response is whether concerns over conflicts of interest management expressed in 5.51-5.54 are really sufficient to justify a structural remedy to require independent oversight. Clearer regulatory definitions and a properly applied senior managers regime shall provide the necessary incentives to individuals in firms to fulfil their duties and to ensure that investors' best interests are considered. This is particularly the case given that the FCA recognises that there are commercial areas where conflicts might arise but which are managed appropriately. Furthermore, as we note above, concerns about poor management of transaction costs, deriving from the best execution supervisory work, are best addressed at the level of underlying portfolio manager.

306. It would be helpful to get further details on the supervisory experience regarding the challenge brought by independent directors identified in 5.49. It would also be useful to have further clarity on the sample size of firms within the supervisory initiative and whether the FCA can provide additional insight on the representativeness of the findings.

Limitations of importing models

307. There are two major structural options that draw on external experience – Option D (Additional governance body) and Option E (Replace existing governance structures with new body). We recognise that the consideration of independent directors is common to C and E, but these two options differ in the extent of the change. In this regard, arguably the more radical of the two is Option D which borrows the IGC model from the insurance industry. For reasons that we have already touched on, this appears inappropriate and certainly premature:

- IGCs emerged out of a Market Study based on both a different market and different findings as to the nature of the problems on the demand side of that market. In particular, the OFT concluded that the role of the employer in designating pension schemes for employees constituted a particular challenge with respect to expertise and decision-making, which justified consideration of a major supply side intervention. Although there are direct investors using funds, the prevalence of professional intermediaries and informed gatekeepers in the retail market makes it hard to see any justification for the IGC model in the asset management industry.

- IGCs are only just approaching their second anniversary and therefore are not tried and tested. While we do not question the policy decision that led to their creation, or have any reason to judge their work to date, there has been as yet no post-implementation analysis as to their effectiveness and more specifically the characteristics that underpin effectiveness.

308. In general, the IA urges caution about regulatory 'copy-paste' across different sectors and is also cautious about Option E (US mutual fund model). While international best practice within sectors does offer scope for lessons to be learned between jurisdictions, the nature of the US mutual fund model and associated consumer protections has a wholly different history and is delivered in a different legal context[115]. A majority independent board may have had justification historically where there was no other significant independent oversight, but does not appear well adapted to the long-established European protection model provided by depositaries/corporate trustees and the AFMs; nor as noted above, to the legal structure of a unit trust itself.

309. This in turn raises the question of whether this European protection model itself could not be adapted to provide some form of halfway house – full functional independence delivered in a wholly different way to the US mutual fund model (Option F – Greater duties on trustees and depositaries). We agree that the role of the depositary/corporate trustee is an important source of independent oversight across a range of key areas[116] and the Option raised by the FCA is understandable. Our view at this stage is that given the commercial agreement between AFM and depositary/corporate trustee to facilitate operational scrutiny and safeguarding of assets, we question whether overlaying a VfM function is appropriate, let alone a wider-ranging fiduciary obligation about fees.

Lessons from Europe and the US on the role of independent oversight

310. One critical point in looking at the difference between Options A, B and C is the proportionality of a remedy that introduces independent oversight. Ireland and Luxembourg both require independent fund board directors. However, these models are clearly focused on a corporate governance framework for investment companies, and are not set up to discharge a specifically defined VfM judgement. In practice, this means a much broader focus on fund operations (e.g. creation of share classes, changes in investment objectives, appointment of services providers, anti-money laundering prevention etc.) than a focus specifically on VfM.

311. The UK Government considered and rejected the introduction of independent directors, as a requirement, when introducing OEICs in the mid-1990s. While non-exec directors are permitted, the view was taken that it might be difficult at that time to find a cadre of suitably qualified candidates given the existing scale of the UK funds industry; that existing regulation would provide specific protections; and we infer that proportionality militated against mandating the presence of independents. A significant number of UK asset management

[115] Since the 1940 Investment Company Act, independent directors have had explicit duties, as checks on management in five areas; in the 1970s this was extended into rate-setting under section 36b and depositary-like roles rejected; in the 1990s they were seen as oversight "partners" (Levitt, 1995) with the SEC; and post 9/11 could be seen as overseers of business risks too [per Fink and Edwards, the Investment Lawyer Vol23, No.4]. Additionally the nature of the US fiduciary duty is legally quite different from English law references to fiduciary.

[116] See COLL 6.6 in particular.

groups have joint management companies that act as both, UCITS management company and investment manager. This structure makes it even more difficult to find suitable independent directors. We acknowledge that this was looking at the directors at fund Board level. If the independent directors were at AFM level then there is a very different scale of requirement than if they sat on a fund board as such.

312. In terms of comparative US and European models, the Final Report would benefit from greater exploration of the justification for using the US governance model cited in Chapter Ten, as well as from extending the governance analysis to other jurisdictions such as Ireland and Luxembourg. In support of this goal, we document a number of points from international experience in our response.

313. Our analysis, indicates that there is little evidence that the nature of the independent governance structure has led to systematic change in the competitive dynamics of domestic investment fund provision in any jurisdiction. In the United States, for example, the FCA cites data on aggregate falling fees over the past 10-15 years, but in the 1990s fee trends were very different with similar governance structures. A central conclusion from the United States is that competitive dynamics are not being driven by governance structures, but by a combination of other factors, including intense product competition between active and passive in a depth of market heavily shaped by very significant use of mutual funds in the delivery of retirement income products. For example, the Investment Company Institute (ICI) report that the $7.1 trillion in mutual fund retirement assets made up 46% of all mutual fund assets at year-end 2015.[117]

314. There is little evidence either from Luxembourg or Ireland that independence per se drives competitive dynamics (this, of course, is not to say that there cannot be proper debate as to whether it improves governance or challenges in other areas). It is at the core of our argument that such dynamics are already, and will continue to be, facilitated within the market by demand and supply side interaction, particularly post-RDR (see discussion in Part Two).

315. Additionally, we would urge the FCA to do a thorough cost-benefit analysis of the proposed models. As with any model, the US model has its own conflicts of interests. In particular, given our comments about facilitating mergers and asset transfers, consideration would need to be given to address any incentive that independent fund boards may have to resist fund mergers (since many or all of the individuals are then invariably redundant).

316. If greater external oversight is to be introduced, then it would need to be done for clearly articulated and evidenced reasons, which in our view would need to relate to wider governance considerations.

Alternative Option: Fiduciary duty

317. The debate has come at a time when increasing regulatory and political interest has been shown in the issue of fiduciary responsibility. This is a more recent iteration of a long running debate. The Law Commission had already published in 1992 a consultation paper on fiduciary

[117] ICI, *2016 Investment Company Factbook*, Figure 7.23.

duties and regulatory rules[118]. It coined the terms "status-based" approach and "contract first" approach. The status-based approach imposes obligations on the basis of the fiduciary and beneficiary's relationship (as set out above) rather than anything they have agreed.

318. By contrast, the contract first approach gives primacy to what has been agreed and then considers whether there are gaps into which the fiduciary duties may attach. The contract first approach has been supported in the courts[119] and reconfirmed in subsequent Law Commission papers[120]. This means that even where the parties have a relationship that could give rise to a fiduciary duty, the commitments the parties have made in their contract may override it. Fiduciary duties are therefore presently default positions which parties are free to adapt to the commercial circumstances, subject to relevant regulatory requirements.

319. The Law Commission undertook another major project in 2013/14. [121] This work covered a range of actors through the investment chain, from pension schemes through to investment managers and other parties, such as investment advisers and custodians.

320. The Law Commission stopped short of recommending significant changes to the legal definition of duties in the investment chain, particularly as applies to investment managers. Indeed, the report provided a fairly forthright commentary on the reluctance of the UK judiciary to assign fiduciary responsibilities in commercial relationships, and to view the concept of fiduciary responsibility as a broad starting point rather than as a clear source of direction with respect to how duties may have been exercised. Instead, courts have been far more influenced by the regulatory regime.[122]

321. We do not think that the debate is usefully advanced by further discussions as to whether there could or should be a statutory duty of care under general law in the sense of a fiduciary duty under English law. There is a clear duty of care defined by FCA rules, European and UK law and contract. The UK regime is based upon the FCA making rules within the wider legal context and relying on such rules rather than a self-standing fiduciary duty would seem more appropriate if any change is required. We reiterate that the Consumer Panel itself noted that the best interests rule from the EU was the sort of remedy it was looking for, and that is already in place for asset management.

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[118] Fiduciary Duties and Regulatory Rules (1992) Law Commission Consultation Paper No 124

[119] Kelly v Cooper [1993] AC 205 and confirmed in Fattal v Walbrook Trustees (Jersey) Ltd [2010] EWHC 2767 (Ch) at [113].

[120] [Fiduciary Duties and Regulatory Rules (1995) Law Com No 236 para 7.3.]

[121] Law Commission, *Fiduciary Duties of Investment Intermediaries*, 2014.

[122] It is not just Courts or contracts. Parliament in s 139(1)(c) FSMA 2000 authorised the FCA to make rules to allow firm to retain some of the interest on client bank accounts – this was a deliberate statutory over-ride of a fiduciary obligation.

PART SIX: REGULATORY FRAMEWORK

Summary

322. A range of issues arise in the Interim Report where the IA considers that regulatory change may be particularly necessary, focusing on barriers to switching (whether from legacy share classes or other situations in which fund managers might wish to close or merge share classes). We would like to work with the FCA to ensure that fund managers are more easily able to move investors to better value share classes and we argue for a sunset clause on trail commission to UK financial advisers. We also believe that there are several areas in which enhanced regulatory processes could facilitate fund mergers/closures of uneconomic or persistently underperforming funds, again to the benefit of investors.

Section 1 – RDR legacy issues

323. We welcome the FCA's note of industry concerns regarding regulatory barriers to investors moving to clean share classes[123] and revert to our earlier observation in Part Two that the structure of the retail market has been heavily impacted by RDR. The IA recognises that the RDR has brought significant benefits, including higher qualification standards among advisers and greater visibility of adviser charges but notes that there remain some challenges following the implementation, notably an indefinite period of trail commission payments for advice offered pre-RDR and a significant number of investors remaining in legacy share classes.

324. The IA welcomes the FCA's proposal to explore raising investor awareness of the existence of trail commission. However, this remedy on its own is likely to have a limited impact on the number of investors paying for adviser charges on trail commission terms and moving from legacy share classes into better value share classes. Two key issues may facilitate and accelerate change: trail commission sunset clause and FCA guidance on switching investors.

325. We continue to believe that a sunset clause on the payment of trail commission to UK financial advisers provides the best way to achieve a single retail distribution regime. This could be achieved with a transition period, enabling both fund managers and advisers to plan and implement the necessary changes to their business models.

326. Whether or not trail is subject to a sunset clause, there is also a critical practical challenge. The guidance issued by the FCA in FG14/04 has effectively prevented managers from being able to move investors from legacy share classes into better value share classes without their explicit consent, which in practice can be difficult to obtain. While we recognise that this is a complex area, FCA guidance should be revisited to enable managers to utilise powers provided in scheme documents to move investors into better value share classes.

[123] Paras 9.41-9.42, p.180.

Section 2 – Fund mergers and closures

327. The IA notes the FCA's comments on closing and merging funds and "survivorship bias" and responds in Part Four. The ability to close or merge a fund efficiently and cost-effectively is important to ensure that investors can be moved to better performing funds and realise any cost efficiencies. With this goal in mind, the IA explores three key barriers it has identified to closing and/or merging funds:

- UCITS Cross Border Notification Requirements
- Taxation
- Application Process

1. RDR legacy issues

328. The UK funds market continues to be highly intermediated, both by independent financial advisers and other forms of gatekeeper having an influence on retail consumer behaviour. FCA intervention through the Retail Distribution Review (RDR) has had a significant impact on the structure of that intermediation. This has resulted in some very positive outcomes, including enhanced adviser qualifications and the ability to judge investment fund outcomes more directly in the context of investment fund charges (cost of investment) rather than a full bundled fee (cost of ownership including platform and adviser costs). However, the changes have also created a number of practical challenges for managers.

329. Our response identifies some of the legacy issues relating to RDR, in particular the indefinite legacy trail commission arrangements to advisers in respect of investment advice provided before 31 December 2012, and the number of investors remaining in legacy share classes. In this context, legacy share classes is taken to mean share classes pre-dating RDR, on which trail commission was typically paid by the manager to an intermediary such as a financial adviser, a broker or a fund platform. For new investments, these share classes have largely been replaced by cheaper share classes which do not pay trail commission. These new share classes are also commonly available to legacy clients.

Trail commission to financial advisers

330. Paragraph 10.31 of the Interim Report states that the FCA does not intend to revisit allowing asset management firms to continue paying trail commission to advisers. Instead, the FCA wishes to explore how best to raise investor awareness of the existence of trail commission and the possibility that they could be better off switching to a different share class (recognising this might not always be the case).

331. The IA welcomes the proposal to explore raising investor awareness of the existence of trail commission, and is willing to work with the FCA and other stakeholders on initiatives to raise investor awareness and assist, where it is able, in the promotion of such initiatives.

332. While recognising that there are a range of competing considerations, the IA is disappointed that there has been no sunset clause for trail commission to advisers. It is reasonable for advisers to be remunerated over a period of time for advice given at the start of the investment, but we question whether such payments over time should be indefinite (particularly if the investor is no longer receiving a service from the adviser). Such a clause, with appropriate transition periods to facilitate planning by both advisers and managers, would signal the end of a dual regulatory regime and also serve to facilitate the kind of VfM consideration and reporting that we discuss in Part Five. Managers cannot in an unbundled environment express a view on VfM where a bundled share class also covers distribution and advice costs.

333. The IA has also argued, for some years, that regulatory clarity would help firms to move forward unilaterally. Such a signal provides practical and commercial impetus, as well as industry consistency on timing. Initiatives to raise investor awareness have gone some way to moving investors into post-RDR adviser charging arrangements and clean share classes. However, this will only be a partial remedy, since such initiatives rely on investors to take action.

334. The experience of our members who have already written to investors in bundled classes to draw their attention to the availability of clean share classes indicates that while some investors will take action, a significant number will fail to act. In many cases correspondence will simply be ignored or put off until appropriate later time. It may also not be clear to investors whether they are paying trail commission or, where they are, if they would be better off continuing to pay trail commission or moving to a different arrangement, e.g. switching to a cheaper share class and paying the adviser's fee separately or switching to another adviser. There may also be investors which the manager is not able to contact, such as those which are "gone away" (i.e. no longer at the address on the Manager's records and have not notified them of their new address).

335. As such, the IA, while supporting initiatives to raise awareness among investors, does not believe the FCA should rely solely on this remedy to ensure investors are moved into better value share classes.

Moving investors into better value share classes

336. While a sunset clause on trail would be helpful, there are practical challenges that arise regardless. Since RDR, a number of investors have, where they are eligible, chosen to move from bundled share classes, which were priced to include cost of distribution, including trail commission payments to financial advisers and other intermediaries, into the cheaper unbundled or "clean" share classes. However, a significant number of investors who would otherwise be eligible to move into a cheaper share class have not done so, and the IA agrees that these investors should be an area of focus for the FCA.

337. The guidance issued by the FCA in 2014 on conversions to 'clean' classes post-RDR (FG14/04) indicated that it is not possible to move investors to another class unless they explicitly consent to it. This was not in line with what the industry's understanding had been prior to the guidance

being issued, and in a number of cases this has prevented firms from reorganising their funds for best investor outcomes.

338. Firms wishing to close pre-RDR share classes are not, based on the guidance in FG14/04, able to move shareholders to another share class, even where moving would not disadvantage them. Should it wish to close a share class, the firm's only option would be to force redeem any shareholders who have not responded to the firm's request for consent to the transfer. As well as interrupting an investor's returns in the fund, this could result in a tax liability for the shareholders (which they might not incur on a share class conversion).

339. Prior to the guidance in FG14/04 being issued, there was a common understanding that, provided the prospectus included the necessary powers, a manager could, on providing sufficient notice to investors, move shareholders from one class into another class, e.g. to combine share classes. Before 2014, schemes of consolidation were used by many managers, and approved by the FCA Fund Supervision team, to combine share classes, upon providing a reasonable period of notice to investors.

340. The guidance in FG14/4 has left considerable uncertainty in the industry. It is not clear to firms whether this guidance was actually intended to remove the possibility of an FCA-approved scheme of consolidation. These schemes, for which firms both seek FCA consent and write to investors, are used as a practical means by which to rationalise offerings. In practice, it can be extremely difficult to obtain specific consent from every shareholder in all cases. If unanimous consent cannot be obtained, managers will either need to run indistinguishable share classes in parallel, 'soft close' them, or redeem the affected investors.

341. There are also a number of apparent inconsistencies between the guidance in FG14/04 and the COLL rules, some of which are summarised below:

- COLL 4.2.5 R (5)(d) requires the prospectus of an authorised fund to contain information as to *"where a mandatory redemption, cancellation or conversion of shares from one class to another may be required, in what circumstances it may be required"*. This necessarily suggests that shareholders can be compulsorily converted from one class to another.

- The most obvious negative outcome from a scheme of conversion (an increase in type or amount of fees) can still be achieved for any share class on 60 days' notice to investors within the rules.

- A scheme of arrangement, whereby two funds are merged, can have a much more drastic effect on the affected shareholders and even this can be effected by a special resolution rather than by unanimous consent.

342. While we recognise that this is a complex area, we are not aware of any legislative barriers, e.g. in the OEIC Regulations 2001 (as amended) or the Financial Services and Markets Act 2000 (as amended), that prevent firms from performing a mandatory conversion of shares from one share class to another, provided the Prospectus includes the necessary provisions empowering

the manager to do so and outlines the procedure the manager will follow when it exercises these powers.

343. We are aware that in some cases the FCA Fund Authorisations team has approved schemes of consolidation where these do not relate to RDR, and where these apply to all investors in the share class, but continues to refuse to approve mandatory conversions where these relate to RDR changes due to FG14/04. This is inconsistent – we would argue there is no logical reason for a different application of the rules for conversions which arise from reorganisations of funds due to RDR than for any other reason.

344. The IA supports the ability of managers to convert share classes without seeking individual shareholder approval, in order to apply TCF and COLL 4.3. Post RDR, managers have been left with legacy bundled share classes and in some cases a number of these share classes have shrunk to sizes which are non-viable. This issue may intensify with an increasing number of 'old' share classes being left with just a few shareholders.

345. There will be further redundant share classes from April 2017 when bond funds will pay all interest gross – currently a number of bond funds have net and gross share classes. Discussions regarding the conversion process are still ongoing, but unless managers are able to merge share classes more easily, this may lead to managers being forced to maintain multiple share classes despite the share classes effectively being the same (i.e. maintaining two gross share classes).

346. There are additional costs and operational complexities involved in running additional share classes (e.g. each share class needs to be valued separately, separate notifications of creation and cancellation are required for each share class, a KIID is required for each share class, etc.). While additional share classes are much more economical than having separate funds, redundant share classes are an unnecessary cost to the fund and therefore the investors. It is in the interests of investors that firms are able to easily close redundant share classes and/or move investors to other share classes with the same or more favourable terms.

347. As the FCA indicates in Figure 10.1, many bundled share classes will include investors for whom trail commission is still being paid on their holdings (e.g. advised, offshore or institutional) but they may also include investors for whom trail commission is no longer being paid. Even if the FCA remains unpersuaded regarding switching share classes where trail commission is paid, at the very least, where the manager has the relevant powers it should be able to move those investors on whom trail commission is not being paid to a cheaper unbundled share class through a bulk conversion. This would ensure investors no longer on trail terms can be moved to a better value clean share class, while leaving the share class open to investors for whom trail commission is still being paid.

348. The IA therefore requests that the FCA revisits its guidance in FG14/04 to ensure that managers are able to utilise powers (where these are provided for in the prospectus) to undertake mandatory conversions to move investors into equivalent or better value share classes, whether this has arisen from RDR or for any other reason.

349. The IA recognises that firms will need to consider the impact on non-UK investors, since tax will impact at investor level and tax reliefs secured by firms for UK investors in the fund would not necessarily be available to non-UK investors. As such, firms would need to ensure investors are given sufficient advance notice of any bulk share class conversions.

2. Fund mergers/closures

350. The Interim Report notes that a number of funds which have performed poorly have been liquidated or merged into other funds, citing that 35% of equity funds which performed poorly over 2005-2010 subsequently closed or merged over 2011-2015.

351. The closure and merging of funds indicates a competitive market as poor funds are forced out or taken over. The best interests of investors in the fund should always be considered before it is closed or merged, however closing or merging a fund may be necessary in order to move investors from an underperforming fund or to realise cost efficiencies.

352. It is therefore important that where the closure or merger of a fund is required, there are not undue regulatory barriers to effecting the closure or merger of the fund, to ensure the process is cost-effective and as efficient for investors as possible to minimise disruption. The IA has identified the following key barriers to the merger and closure of funds:

- UCITS cross border merger requirements, in particular the requirement to issue a notice in a durable medium to investors in the continuing fund
- Taxation – realisation of assets from a fund closure is likely to be a taxable event for many investors
- FCA Application process

UCITS bross border merger requirements

353. One of the aims of UCITS IV was to enable a reduction of the number of sub-optimal and inefficient UCITS throughout the EU by allowing cross border mergers of UCITS. But under the Directive, notice of a prospective cross-border merger of two UCITS has to be given in writing to shareholders in the receiving UCITS, regardless of the size of the merging UCITS and its consequential impact on the receiving UCITS. This requirement extends where either the merging or receiving UCITS have been registered for marketing in other jurisdictions, even if both UCITS are domiciled in the same jurisdiction.

354. In practice it is costly to meet these requirements, to the extent that the merger may no longer be cost-effective, particularly where the receiving fund has a large number of shareholders. There is a real risk that this efficiency could falter at the outset, if it is not recognised that the benefits of a merger could be outweighed by the costs of undertaking the merger in certain circumstances. Indeed, the notification requirements could have the unintended consequence of endangering domestic mergers in the future if similar requirements are copied across to domestic mergers.

355. The difficulty relates to the requirement in Article 43 of UCITS Directive that requires the information to be provided to investors in the receiving UCITS provided on paper or (where certain conditions are met) another durable medium. We do not see why there should be a specific requirement to provide this information in writing which is a different manner than any other information to the shareholders (invitation to a General Meeting, change in the name of the fund, etc.), for which there is currently no harmonisation at EU level.

356. We suggest that it should be left to existing national laws of Member States to provide for how documents and other information may be notified to existing investors. In particular, this requirement should not be extended to domestic mergers of UK funds.

Taxation of investors

357. The IA recognises that the tax arrangements of other Member States are beyond the FCA's remit, but has included this issue since taxation can act as a barrier to greater efficiency of funds. Although UK tax legislation provides for rollover relief, where UK funds have a large number of non-UK investors, taxation can still form a barrier to mergers of funds in the UK.

358. Both cross border and domestic merger events are still treated as taxable in many jurisdictions. While tax relief is potentially available to UK investors in the event of a merger or reorganisation, this may not apply to all investors, in particular overseas investors in the merging fund who may be subject to different tax regimes.

359. At present, managers who wish to merge or reorganise funds (both domestically or cross-border between EU Member States) are faced with a complex range of differing tax consequences. A merger or reorganisation of funds within the EU is more likely than not to result in a tax event, and this is most prevalent at the investor level. A manager may decide to merge if he is seeking greater efficiencies and cost savings, but if that merger will trigger a tax event for many investors, it is less likely to happen.

360. Most Member States impose a tax charge on at least one of the merger types but there are exceptions, most notably in the UK and France. Tax legislation in the UK provides for a capital gains tax rollover relief for funds where a merger occurs or where there is a reorganisation of the share capital in the fund, provided certain conditions are met. The result is that the 'new' assets are deemed to have been acquired at the same date and the same cost as the 'old' assets, and does not trigger a taxable event for the investor. This applies to domestic, foreign and cross-border mergers – in effect, tax neutrality is achieved.

361. At the other end of the spectrum, at least two Member States consider all kind of mergers and reorganisations (domestic, foreign and cross-border) as a taxable exchange of shares, or as a sale of shares followed by an acquisition of new shares. Other Member States provide for tax neutral domestic reorganisations, but impose a tax charge on foreign or cross-border mergers. Some Member States simply lack the certainty in domestic law to be able to exclude the possibility of taxation.

Application process

362. There are inefficiencies in the process of applying for a merger and/or a termination/wind-up, which increase the cost and time taken to merge and/or terminate/wind-up a fund, and which would be in the power of the FCA to address:

- Mergers – an application for authorisation to the FCA is required for a merger. Once the merger is complete, the merging fund will need to be terminated or wound up. A separate application to the FCA is currently required for this process, despite this being the logical and inevitable outcome of a merger. The requirement for an additional application, accompanied by a solvency statement, adds around two months to the process before the termination or wind-up of the scheme can commence after the scheme of arrangement has taken place. This also results in the manager of the fund incurring additional costs (the costs of a merger and subsequent termination will vary significantly depending on its complexity, but we estimate that having to prepare a separate application for termination increases legal and audit fees by around 20-30%). It would be more efficient and cost effective if both the application for the merger (by way of a scheme of arrangement) and the subsequent termination could be completed on the same application for approval.

- If the fund is an OEIC, a separate application to receive the assets has to be made by the receiving fund as well. Again, it would be more efficient if this could be covered on the same application for approval. The IA would welcome the FCA making changes to merger applications to facilitate a more efficient overall merger process.

- Wind-up of an umbrella with more than one sub-funds – the manager is required to wind up an umbrella if all sub-funds in the umbrella have been terminated. However, if an umbrella has more than one sub-fund, and all sub-funds are being terminated, an application must first be made to terminate each sub-fund, then a separate application be made to wind up the umbrella. This adds additional costs and inefficiencies to the process for terminating and winding up the sub-funds and the umbrella. Not only are two separate applications required (incurring legal costs for each wind-up), but each must be accompanied by an audited solvency statement and separate termination and wind-up accounts completed. (The costs of winding up umbrellas with more than one sub-fund will vary significantly depending on the complexities involved, but we estimate that having to prepare a separate application for winding up the umbrella will also increase legal, audit and administration fees by around 20-30%). In such cases, if a single application could be made to wind-up both the sub-funds and the umbrella, this would reduce the legal and audit fees required to wind up the sub-funds and the umbrella. As with the fund mergers, the IA and fund sector would welcome the FCA making changes in the application approach to facilitate a more efficient wind-up process.

PART SEVEN: INSTITUTIONAL MARKET

Summary

363. The Interim Report covers a broad range of areas regarding the institutional market. While solutions such as pooling may be effective in some areas, a number of core principles are clearly fundamental in helping to facilitate good outcomes. We identify the importance of enhanced transparency from the industry and enhanced investment governance at the client level. Improvements in these areas, alongside changes to the way in which investment consultants operate, notably bringing their activity into the FCA's regulatory perimeter, will help the institutional market operate more effectively.

Section 1 – The nature of competition in the institutional market

364. The Interim Report's analysis of competition in the institutional market has focused on the correlation between pricing and past performance. Institutional investors take into account a broader range of factors when choosing asset managers, which should be considered when assessing how competition works in the institutional market.

Section 2 – Commercial agreements between managers and clients

365. MFNs and NDAs are fundamentally different in nature. MFNs are typically put in at the request of investors to provide reassurance that they are getting the best deal. NDAs are infrequently used but where done so, they are signed voluntarily in the context of bilateral private negotiations for tailored services. We do not see either type of clause as inherently inhibiting competition.

Section 3 – Performance of institutional products

366. The Report finds that on a gross basis both consultant recommended and non-recommended institutional products on average outperform their benchmarks, a point that is deemed worthy of further investigation. A range of factors may explain this finding, and we note that the benchmarks are generally chosen by investors and advisers, not the manager.

Section 4 – Transparency of costs and charges and performance presentation

367. The IA strongly supports the need to provide accessible, comparable and consistent information on product charges and transaction costs across all the markets. A new IA Disclosure Code will provide for consistent and granular disclosure of all charges and transaction costs to both retail and institutional clients. On performance, we discuss our understanding of how clients interpret performance information and the role of GIPS in providing clients with standardised, comparable performance information.

Section 5 – Role of pooling and importance of good governance

368. Pooling of pension scheme assets is likely to bring some costs down in the long run due to increasing bargaining power on the part of pension schemes, but the long term benefits are

uncertain, with no evidence to suggest that this will improve performance. We see a focus on good governance as crucial in driving good investment outcomes for clients.

Section 6 – Role of investment consultants

369. We note the provisional decision to make a Market Investigation Reference in respect of the institutional advice market. It is essential that this market works effectively and competitively. We strongly support the proposals to bring institutional investment advice and EBC advice to trustees and employers on pension scheme design into its regulatory perimeter. We also provide a view on how to achieve this in a way that does not impede wider conversations with clients on capital market and asset allocation issues.

370. In regards to gifts and hospitality in the investment consulting sector, the value of expenditure in this area has fallen in recent years and we expect it to fall further as a result of further FCA guidance on inducements. However, current rules seem focused on retail investment business and we consider further clarity would be helpful in respect of institutional asset management.

1. The nature of competition in the institutional market

371. The Interim Report's analysis of competitive dynamics in the institutional market focuses on the correlations drawn between pricing, past performance and competition. This is particularly evident in the institutional market econometric analysis, where product flows are largely specified as a function of a number of variables focused on price and past performance (alongside consultant recommendations). While price is of course important, this focus is to the exclusion of the broader based competitive forces in the institutional asset management market whereby managers are selected by a much wider set of criteria, including (though not exclusively and in no particular order of importance):

- Stability of organisation;
- Consistency of investment process;
- Investment research capabilities;
- Access to portfolio managers;
- Alignment of compensation and reward between an investment manager and their investors;
- Variety of investment strategies and the ability of managers to grow with their clients over time;
- Organisational values, culture and ethics; and
- Internal control and risk management frameworks.

372. While most of these factors have been identified by institutional investors themselves (see figure 4.4 of the FCA report) as being important when selecting asset managers, there is little discussion of them in the Interim Report. A complete analysis of the competitive dynamics in the institutional asset management market would also need to include a consideration of these broader factors.

2. Commercial agreements between managers and clients

373. The FCA has looked at the role of MFNs and NDAs and concluded that for now it has insufficient evidence of the competition impact of these clauses to be able to propose any changes in these areas.

374. MFNs and NDAs are fundamentally different in purpose and nature. The former are client-driven and designed to provide reassurance for the client that they are receiving the best possible deal. NDAs, where used, are signed in the context of bilateral private negotiations for tailored services (not the purchase of an 'off-the-shelf' product available to all) and their use is not unique to the asset management industry.

MFNs

375. Our understanding is that the use of MFN clauses in the UK institutional market is not commonplace and driven primarily by large clients and their consultants, who typically request them for their own comfort, as it provides them with a guarantee that they will not be charged more than other clients for the same strategy. Were they to be discouraged or banned, we expect that while institutional investors might be concerned, the behaviour of asset management firms would not be affected.

376. One possible unintended consequence of them is that in sub-segments of the market where there are a relatively small number of clients, if MFNs become the norm they hinder asset owners' ability to negotiate with managers and effectively set a floor on prices. Prices would then tend to cluster at that level, a phenomenon that has been observed in some markets overseas.

Price transparency for institutional investors and the use of NDAs

377. In recent years fees in the institutional asset management market have been falling, in response to client demands, across all institutional client types. This has been driven by a highly competitive market for institutional asset management products and services. In addition to the use of sliding fee scales, managers commonly offer further discounted fees to clients, a point consistent with the FCA's own findings presented in para 6.69 of the main Interim Report and Annex 5 on the institutional demand side, in which the FCA notes that it has heard examples of institutional investors securing discounts.

378. While there is some use of NDAs in the institutional market, institutional investors and their advisers do have price transparency on management fees. Investment consultants collect data on fees as part of the research process they conduct on managers and, where done, RFPs

usually involve fee schedules being submitted as part of the process by which managers compete to win mandates. The buy lists that consultants compile also include data on management fees. Thus, the demand-side of the market (institutional investors and investment consultants together) knows what different managers charge and what the going-rate in the market for a particular product is.

379. Where there is less price transparency in the institutional market is on the supply side, where asset managers have less visibility over what competitors are charging due to the client-specific nature of pricing that is common in this market. Managers can use sources of market intelligence (such as consultant surveys and market intelligence providers) as well as feedback on pricing from RFPs where they have been unsuccessful to discern pricing conditions in the market, but on the whole there is less visibility for managers than there is for consultants and institutional investors. We do not consider this to be a significant problem for competition in the institutional market.

380. The use of NDAs in relation to management fees agreed with clients is far from universal, a point confirmed by the FCA in its report (see para 4.69 where only just over 20% of respondents to the FCA's online survey – around 20 responses of a total of around 90 – reported signing NDAs). Where they are used this may be to the benefit of institutional investors to the extent that it can help them negotiate lower prices than other investors (and explains why clients insist on them almost as much as firms do). In any industry, larger clients will benefit from greater negotiating power.

381. When each transaction is specific to the circumstances of the client it is not clear that prohibiting the use of NDAs would help. We would in any case note that the FCA's findings suggest that large clients were the ones being asked to sign NDAs and that they stated that they could refuse to sign these clauses if they did not wish to. As such, we share the FCA's view there does not appear to be any evidence that these clauses harm competition in the market.

382. As a final point the use of NDAs is not necessarily about keeping information on fees confidential. There are some asset classes, typically in private markets, (for example, infrastructure debt, commercial real estate, private equity), where transactions generally involve access to non-public information. In these instances asset managers are required both to create Chinese walls internally between public and private market participants, and to sign an NDA as part of the investment process. Managers are in turn required to ensure that this NDA is extended to their underlying clients where they too may also be given access to material non-public information from time to time. As asset managers involve themselves more widely in private markets we expect that the use of NDAs for such reasons is likely to increase.

3. Performance of institutional products

383. The FCA reports that on a gross basis both consultant recommended and non-recommended institutional products on average outperform their benchmarks, a point that is deemed worthy of further investigation in the FCA's view. It would be helpful to have more clarity about the nature of the data used, including the composition of the underlying product set examined (i.e.

the mix between segregated mandates, investment vehicles used only by institutional investors and investment vehicles used by both retail and institutional investors).

384. The outperformance point touches upon the assumption that all asset manager investment activity is a zero sum game – an argument used also in the analysis of the returns in the retail market.[124] Although it is certain that the combined activity of all participants in a given market will produce the 'market return', the asset management industry does not represent 100% of the market and that there are other types of investors that could be underperforming on a relative basis (an issue explored in more detail in Annex One). Furthermore, we would note that such a debate is only relevant in the context of public markets. It does not apply to private market investments, an area where institutional investors are increasingly allocating assets.

385. Alongside the possibility that there could be genuine outperformance, two possible explanations are offered by the FCA for further investigation (with an additional two ruled out), both centred on the possibility that the benchmark has been chosen or calculated in a way that could artificially overstate the performance of the products in question – a possibility that we disagree with for a number of reasons.

386. First, the implication of the two explanations offered is that asset managers choose the benchmarks against which their institutional products are measured for the purposes of reporting performance to their clients. It is not sufficiently clear what part of the institutional market is covered in the FCA analysis of recommended products in Annex 6. It is only stated that the analysis looks at *"gross returns …in excess of manager selected benchmarks"*.[125] While managers do select the benchmarks that are captured in the eVestment database, the investment objectives of a mandate and the appropriate benchmarks on which they are actually judged are most often agreed by a client and consultant before a mandate is even pitched for. By the time the manager search begins these features are typically already set and the manager cannot alter them.

387. In those instances where this is not the case this is because more sophisticated clients want to discuss appropriate objectives and benchmarks directly with the manager. Where this happens feedback might be invited from the manager but the client has the final say. In neither case does the manager unilaterally specify the benchmark. We therefore do not see what ability the manager has to select a favourable benchmark – on the contrary there appears to be significant third party and client influence on the selection of the benchmark, a point underscored by paragraph 4.94 of the Interim Report as well as figures 19 and 22 of Annex 5 of the Interim Report.

388. Institutional investors also have the capability to compare their performance against any benchmark they choose and many of the larger investors run independent performance calculations by their custodians. This gives them the freedom to use any benchmark as a comparison. The benchmark is often used as a guide to the investment universe that the client wishes to access, though by no means a strict parameter as the manager will be expected to

[124] For example, see para 6.32, p.97.
[125] Annex 6, para 68, p.14.

vary from it according to his or her investment beliefs (subject, in some cases, to a maximum tracking error at the client's request – as well as more general investment guideline restrictions). Perhaps the most important reason why clients and consultants want a benchmark is to give them something to measure performance against – that is the key driver by which they assess their choice of manager and the value-for-money of the offering. So even with benchmark-agnostic strategies, there is a desire for a benchmark to be able to calculate relative performance to the kind of outcomes that the client is seeking.

389. Performance as measured by the FCA also appears to be based on a narrow interpretation of investment objectives. Annex 5 of the Interim Report states that the conclusion is based on looking at the returns of recommended and non-recommended products and then comparing these to the return of the appropriate benchmark. This assumes that all investment objectives are set in relation to achieving a given level of return. However, this is far from the case – institutional investment objectives are frequently set in relation to other factors such as risk measures, liability hedging or funding levels (e.g. LDI strategies), reflective of the underlying purpose and needs of the investor (e.g. to pay out pensions). More generally, management of investment exposure – as opposed to a narrow focus on returns – is increasingly a significant part of what institutional clients buy.

390. In this context, it should also be considered that institutional investors tend to invest larger starting amounts and follow long-term strategies (in the sense that the money, once invested stays invested for longer), with less drag on performance from having to invest or liquidate for ongoing subscriptions and redemptions. This, along with the different nature of objectives discussed above, may complicate the comparability between the outcomes of institutional products to that of other investor types.

391. It is also important to verify whether there are any nuanced differences between the finer details of a strategy that might otherwise be broadly the same for different classes of investor – for example, if an institutional fund allows for greater volatility than its retail equivalent, then this increased risk profile might also help to explain the greater reward in some cases.

4. Transparency of costs and charges and performance presentation

392. The IA strongly supports the need to provide accessible, comparable and consistent information on product charges and transaction costs across all the markets and client groups served by its members. Investors should be able to see the charges they are paying for an investment management service as well as the transaction costs incurred in the delivery of their investment objectives. If used in the right way this will enable them to make informed comparisons of their managers and assess how effectively the managers deliver their service, in the context of what they are paid to do so. Such disclosure will aid meaningful value for money judgements.

393. It is for that reason that we are developing a new Disclosure Code, intended both to facilitate the intent behind the FCA's draft rules for transaction cost disclosure to the DC pensions market as well as to extend the coverage more broadly to allow all client groups access to

enhanced information. We are grateful to the FCA for the recognition of this work in the asset management study Interim Report.

394. The Code is an ambitious project that goes well beyond current regulatory proposals to provide consistent charges and costs data across our entire product and service market. It has been developed with input from an independent Advisory Board and in collaboration with a range of stakeholders, notably the Local Government Pension Scheme Advisory Board.

395. We will shortly be consulting publicly on a standardised disclosure framework and what this looks like will be set out in detail in that consultation. In developing our Disclosure Code we have proposed a dual approach to detailed client reporting and in particular, core reporting templates to cover the following areas:

- Investment return (gross and net of fees) over various time periods
- Investment activity by asset class – purchases, sales, opening and closing assets. Turnover is also reported at a portfolio level
- Management fees – whether separately invoiced or deducted from the assets of a fund or portfolio
- Performance fees where applicable
- Payments for investment research under forthcoming MiFID II rules, where applicable
- Transaction costs by asset class, including both explicit and estimates of implicit costs
- Costs imposed on investors entering or exiting a pooled fund as a result of pricing policies designed to protect the fund from dilution.
- Income and costs for any securities lending programmes
- The costs of any ancillary services in a pooled fund or arranged by a manager on behalf of a client with a segregated portfolio.

396. Clear and consistent definitions of costs and charges are important in helping investors compare managers and, in order to provide the consistency and standardisation required, all these core data points will have their own definitional tags to allow third party providers to carry out and assist with the assembly of reporting as per specific arrangements with managers or clients.

397. This detailed reporting is in line with the draft rules set out by the FCA in CP16/30. Alongside this detailed level of reporting to institutional investors the code also provides the component parts needed for product distributors to provide the disclosure documents that investors will receive under MiFID II and PRIIPs.

398. The templates are complemented by more detailed reporting approaches in specific areas:

- Pricing policy for pooled funds (as applicable)
- Research payment account disclosure (as applicable)
- Best Execution reporting

399. We propose separate templates for reporting on segregated mandates and pooled funds. These can be found in Annex Five and are capable of capturing the costs of fund-of-fund or multi-manager products, including fiduciary management.

400. The templates will shortly be launched in conjunction with the Local Government Pension Scheme Advisory Board as part of its code of transparency for local authority pension schemes.[126]

401. The templates have been designed to accommodate all major asset classes covered by IA members. However, Private Equity and Hedge Funds, which have a significantly different cost structure to the asset classes our template was designed for, will need a different approach. Given the make-up of the IA's membership our mandate does not extend to Private Equity and Hedge Funds; but we are aware of others doing work in this area.

402. All feedback from our consultation will be reviewed and we will publish a feedback statement and a final set of proposals later this year. Subject to adaptation to any further evolution of FCA disclosure requirements, we will be proposing to the FCA that this is recognised in its COBS rules.

Cost disclosure and value for money

403. While we fully support enhanced disclosure of all charges and transaction costs resulting from the investment process, we have a few additional comments:

- We have already indicated to the FCA via our response to CP16/30[127] that we have serious concerns over the current regulatory direction of travel with respect to the methodology for calculating transaction costs, largely due to its ability to give rise to counterintuitive results – such as negative transaction costs; levels of costs well above the expected range based on historic figures; and index funds exhibiting large costs (positive or negative) due to the way they are traded[128]. As a result it is not clear how trustees and IGCs should interpret such information with respect to reporting on value for money. We do not repeat these concerns in detail any further here.

[126] LGPS Code of Transparency. See the website of the Scheme Advisory Board.
[127] IA response to 'FCA CP16/30: Transaction cost disclosure in workplace pensions', January 2017. Available to download from the IA website.
[128] Index funds typically trade very close to the end of the day in order to minimise their tracking error in relation to the index they are tracking. However, the order to trade normally goes into the market hours before this. Under the FCA's methodology this creates a long time lag between order and execution prices such that market movements can have a significant impact on the reported cost.

- Alongside enhanced disclosure of charges and costs we feel that additional education is required to help investors understand this data and how it should be used, particularly in relation to transaction costs. Understanding of the nature of transaction costs amongst firms' clients is mixed, with not all of them appreciating that transaction costs are incurred in order to deliver the underlying investment objective and that they are therefore already accounted for in the investment return achieved. Unfortunately some of the wider public debate in this area also gives the impression that this is not the case, i.e. there is a misunderstanding that transaction costs (along with the OCF) must be taken away from gross returns to obtain net returns where in fact transactions costs are incurred before gross returns can be delivered. The prevailing climate in which this debate is being carried out suggests that all cost is bad, that high turnover of portfolios is bad and that value for money automatically means low cost.

- Without appropriate context and explanation there is a risk that clients would not understand the nature of transaction costs, resulting in poor decision-making, e.g. comparing two transaction cost numbers in isolation and concluding that a lower number was necessarily better. The reality is that looking at cost alone cannot determine whether a particular investment strategy has delivered value for money or not. For this reason we do not advocate schemes publishing their costs and charges unless it is done alongside the performance that has been delivered.

- More generally, a public focus on cost alone risks exacerbating the problem of value for money being conflated with lowest cost. It is not clear how trustees' understanding and decision-making would be enhanced as a result of being required to simply publish their scheme's costs. On the other hand there is a risk of trustees getting into a race to the bottom in terms of cost-cutting while neglecting their primary focus of helping members accumulate savings in order to pay them adequate pensions. Such a development would not serve the interests of savers.

Measures to improve performance information

404. Historically, institutional asset managers reported performance on a gross-of-fees basis[129] since it was the only way for clients to assess performance on a consistent basis – in a market where fees are negotiated on a client-by-client basis, a net-of-fees presentation is not representative if the fee rates faced by a particular client differ from those used to calculate the net return. Increasingly however, net-of-fees performance for each individual client is also being reported.

405. Clients generally understand performance in headline terms, although not necessarily all the nuances e.g. they might not understand performance attribution analysis. However, managers generally believe that clients are able to assess managers' performance based on the performance information provided. This is particularly the case where managers are being judged against a simple benchmark or objective.

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[129] For the avoidance of doubt 'Gross-of-fees' is defined as the return on investments net of transaction costs but before the management fee is deducted.

406. We highlight the importance of the Global Investment Performance Standards (GIPS) in providing clients with standardised performance information; clients themselves generally understand that GIPS is an industry standard, and that in making a compliance claim the investment manager is publicly saying that they comply with all the provisions of the standards. This public attestation provides further assurance.

407. By standardising the calculation and presentation of investment performance GIPS offers investors the ability to compare different managers and products on a like-for-like basis over time. Firms' performance histories must comply with the requirements of GIPS. An investment manager may further choose to have their claim of compliance with GIPS verified by a third party firm. Verification involves the review of a firm's performance measurement processes and procedures to assess whether these are designed to calculate and present performance in compliance with GIPS.

408. As the FCA notes in its Interim Report asset managers now have a significant commercial incentive to verify their compliance with GIPS. The CFA Institute reported that in 2016 86% of firms that submitted a GIPS claim of compliance to it also underwent third party verification[130].

409. It is not clear from the Interim Report whether the FCA's finding that trustees find it difficult to engage with the performance information given to them takes account of GIPS requirements. However, we would suggest that the finding implies the need to ensure better educational support for trustees in their role – a topic we return to in the discussion on investment governance below.

Disclosure of fiduciary management fees and performance

410. We think the definition in the Interim Report of what constitutes Fiduciary Management is perhaps too narrow in scope. Delegating responsibility for all investment decisions over an entire portfolio to a fiduciary manager is in fact just one variety of Fiduciary Management. Manager-of-Managers and Fund-of-Funds selections for portions of a client portfolio are also forms of Fiduciary Management.

411. Fiduciary Management is a service that is offered by both asset managers and investment consultants, though it is the latter that represent the majority of the market[131]. We agree with the FCA's discussion of the conflicts of interest that can arise with the provision of Fiduciary Management services but note that these conflicts are not inherent in the service. Rather, the conflicts arise in the investment consultant business model where the consultant shifts from an advisory relationship to a fiduciary one. We return to this discussion in the section of our response that deals with the investment consulting MIR.

[130] See the CFA blog '[Out of Top 100 Asset Management Firms Globally, 85 Claim GIPS Compliance]', 6 February 2017.

[131] See '[2016 KMPG UK Fiduciary Management Survey]', p3, Chart 'Number of mandates by type'. By 2016 350 of around 450 full fiduciary mandates in the UK were provided by consultants, with around 50 by specialist fiduciary managers and another roughly 50 by investment managers.

412. Our understanding is that there is price pressure from consultants, as Fiduciary Managers, reviewing the products and services of third party managers.

413. We believe the same levels of disclosure of both costs and performance should apply to Fiduciary Management as to other asset management products. We do not see any additional challenges of cost reporting for Fiduciary Management and as stated earlier, we believe that our proposed cost reporting templates will fully capture the costs of this service. Our earlier comments on cost needing to be seen in the context of performance delivered are just as relevant here, possibly more so since performance metrics in Fiduciary Management will be less likely to be return-focused.

414. We do however see greater challenges with respect to performance reporting. Given that Fiduciary Management is typically used by DB pension schemes what matters most to this group of investors is improving funding levels. However, there are a number of economic and demographic factors driving changes in funding levels, of which investment performance is just one and the nature of Fiduciary Management is that it aims to deliver a bespoke solution. This can make it challenging for trustees to assess whether Fiduciary Management has delivered superior outcomes relative to a counterfactual where it is not used; or indeed comparing the performance of different Fiduciary Managers.

415. We support any move to create a standardised performance framework for Fiduciary Management. However, given the complex nature of DB pension schemes and the factors that drive their funding levels this is an area where there would be mutual benefit in the FCA working with both the asset management and pensions industries in due course to design and agree upon a common set of performance measures for Fiduciary Management.

5. Role of pooling and importance of good governance

416. The pooling of pension scheme assets is ultimately a decision for the demand side of the institutional asset management market and asset managers will compete to deliver the best products and services no matter how the demand side is structured. It should be noted that institutional clients can already access an extremely wide range of pooled vehicles, offering access to scale economies, including more solution-focused products such as LDI.

417. The Interim Report discusses the benefits of pooling of pension scheme assets. In the FCA's view these benefits arise both because increased scale leads to greater bargaining power with asset managers and thus lower costs and also because there is a general trend that the larger the pension scheme, the more likely trustees are to have investment expertise and resource.

418. We agree that pooling of scheme assets is likely to lead to lower investment management costs for precisely the reasons the FCA sets out – pricing in the institutional market moves inversely with the size of the mandate. However investment management fees are but one component of overall costs involved in the investment process and it is not clear if overall costs will fall. Even if they do, it is not axiomatic that performance, and ultimately funding, in the case of DB schemes, will be improved as a result. Analysis of DB funding levels by the Pension Protection

Fund suggests that there is no clear relationship between scheme size and funding level (see Exhibit 14).

Exhibit 14: Weighted average funding ratios of corporate DB schemes as at 31 March 2016

	1-99 members	100-999 members	1,000-4,999 members	5,000-9,999 members	10,000+ members	Total
S179[132]	93.2%	82.6%	81.7%	86.7%	87.1%	85.8%
Buy-Out	66.8%	60.4%	61.1%	64.5%	63.9%	63.2%

(Source: adapted from figures 4.4 and 4.6 of the 2016 Purple Book[133])

419. Furthermore no evidence has been presented to suggest that increased scale alone will lead to better asset allocation decisions, a highly significant driver of returns for any investor. We see the key driver for improved outcomes in the pensions sector as coming through enhanced investment governance, a topic we discuss in more detail below.

420. Ultimately it is too early to know what the long term outcome from asset pooling will be, both in terms of cost savings and performance. The Local Government Pension Scheme is in the early stages of its consolidation – the first assets will not begin being transitioned to the new pools until April 2018 and the full transition is likely to take place over a number of years.

421. While savings from this process are expected – as outlined by the FCA in the case of the London CIV on p71 of the Interim Report – any cost-benefit analysis of asset pooling needs to consider the transition costs of moving to the new steady state as well as any new on-going costs arising in the new steady state itself. The transition costs are non-trivial – estimated by the London CIV to be anywhere between £30.4 million - £103.6 million in its case[134] - and themselves highly uncertain.

422. In addition new on-going costs are being incurred as the emerging pools seek additional funds from their members to pay for increased internal staff capabilities as well as the cost of investment consultancy, custody, audit and proxy voting services. Some of these elements would previously have been paid by the manager from its fee. It is therefore far from certain that pooling will lead to lower overall costs.

423. Whether or not the LGPS pooling reforms are a success will depend upon future performance and funding levels. Here, there is simply no evidence to say with any confidence what will happen. Whether any cost savings could be replicated across other specific pension funds or pension funds more generally is also unclear. Yet these factors too must form part of a wider cost-benefit analysis for asset pooling.

[132] Section 179 funding is the funding level based on benefits paid out by the PPF in the event of a scheme having to enter it. Buy Out funding reflects the cost of buying out benefits in the member's name with an insurance company.
[133] The Purple Book; DB pensions universe risk profile 2016. Available from the PPF website.
[134] Source: 'Proposal for asset pooling in the LGPS – 15 July 2016', London CIV. Available to download from the website of the Scheme Advisory Board.

424. We think that some caution is justified here with a recognition that pooling on its own is unlikely to be a panacea. The LGPS experience is arguably a singular one due to the greater homogeneity in benefit structure (resulting in a degree of homogeneity in liability profiles) and the fact that the public sector ultimately underwrites these schemes. The challenges of pooling corporate DB schemes are likely to be greater, with different strengths of employer covenants and differences in benefit and liability structures. The experience of pension pooling in the Netherlands is also noted by the FCA in Annex 9 to the Interim Report. While this may be a relevant example for the UK in that it relates to large industry-wide multi-employer schemes, this experience has come about under a very different social and labour contract to that of the UK. Furthermore, pooling has not helped Dutch schemes avoid the same issues of underfunding (and in some cases, benefit cuts) common to DB schemes around the world. It would be helpful to draw on this experience when considering its applicability in the UK.

425. There may be greater scope for consolidation in DC pensions compared to DB pensions and this is already happening with the growth in master trusts and contract-based schemes at the expense of single-employer trust structures. Given that this is already happening as a result of market forces it is questionable whether further regulatory intervention is required.

426. The FCA's finding of greater investment expertise of trustees in large schemes and the greater resources available to them is more compelling. However, we would question whether this is a function of size per se or a sign of the importance these schemes place on good investment governance. As we discuss in the next section, this is an area where regulators could focus given the importance of enhancing investment governance among institutional investors.

Importance of good investment governance

427. While the overall impact of pooling is uncertain and unlikely to be realised in the short term, an enhanced focus on investment governance will certainly make a positive difference. Good governance is essential in driving good investment outcomes for clients. While the nature of investing means that nothing is guaranteed, ensuring that the right processes are in place with respect to how scheme investments are selected and monitored may maximise the chances of success in meeting client objectives.

428. At the heart of this process is the setting of appropriate investment objectives – typically done via a Statement of Investment Principles – and then choosing an investment strategy to implement the objectives. This will include making a decision on strategic asset allocation, which as the FCA notes, is a major driver of client outcomes, and an area that it has identified as not always receiving enough attention from trustees (see for example para 8.43 of the Interim Report). This finding is consistent with the Myners review on institutional investment in the UK[135] which highlighted, as long ago as 2001, the lack of resource devoted by trustees to asset allocation decisions.

429. Once these decisions have been made, and managers appointed, the performance of the investment strategy against the objective should be monitored on an appropriate frequency

[135] 'Institutional Investment in the United Kingdom: A Review', Paul Myners, 2001.

and reviewed periodically to ensure that the objectives and strategy remain relevant. Selection and monitoring of managers is part of this process and trustees should also consider the issues around the security of scheme assets.

430. The IA has consistently advocated the need for enhanced investment governance and in 2014 recommended the implementation of an investment governance 'MOT' for DC default strategies (see for example our response[136] to the FCA's CP14/16 on proposed rules for IGCs) which was designed to act as a checklist of minimum standards that all DC default strategies should meet. Much of the thinking in that proposal has now been incorporated into The Pensions Regulator's DC Code of Practice[137] for trustees and the guidance that sits behind it. Although our proposal was designed with DC default strategies in mind the basic concepts are applicable to other types of institutional investor.

431. The Interim Report raises some concerns on the effectiveness of governance structures in the institutional space. Specifically, it is stated that *"trustees have a tendency to rely heavily on investment consultants, Chairs of Trustees and/or professional trustees that they perceive as having greater investment knowledge. This dependency can result in trustees accepting proposed investment strategies without critique or challenge".*[138] It is also stated that *"trustees often fear complexity and looking ignorant in front of their peers. This contributes to their unwillingness to challenge and makes them more likely to accept proposed strategies that they do not fully understand"*.[139]

432. We recognise that there is a wider public policy debate regarding the professionalisation of trustees and the knowledge and skills they need to fulfil their duties. Trustees have a very difficult job with significant responsibility and they need support from regulators, and their service providers, including asset managers and investment consultants, to achieve their task. We see the findings of the Interim Report with respect to the skills challenges faced by trustee boards as an opportunity for regulators and the pensions and asset management industries to improve the quality of education and training available to them.

433. In regards to the academic research on which the Interim Report conclusions are partly based, we would like to point out that the results of the online survey that covered 71 respondents indicated that there is high degree of trust and satisfaction with the effectiveness of oversight committees' decision making and that the qualitative interviews with 22 respondents[140] showed a lower degree of satisfaction and some concerns about the effectiveness of oversight committees' chairs. The authors acknowledge that this difference in opinion may reflect the fact that *"the interviewees were found by targeting an industry group of pension fund transparency activists – these respondents are likely to have self-selected into the lobby group*

[136] IMA response to 'FCA CP14/16: Proposed rules for Independent Governance Committees', October 2014. Available to download from the IA website.
[137] Code of practice no: 13 – Governance and administration of occupational trust-based schemes providing money purchase benefits, The Pensions Regulator, July 2016. Available to download from The Pensions Regulator website.
[138] Para 4.108, p.68.
[139] Para 4.111, p.69.
[140] See Appendix III in Tilba, Baddeley and Liao, *Research Report on the Effectiveness of Oversight Committees: Decision-Making, Governance, Costs and Charges*, 2016.

and are likely to share a particular perspective on decision-making within pension fund oversight committees".[141]

6. Role of investment consultants

434. The IA notes the FCA's provisional decision to make a Market Investigation Reference (MIR) to the CMA in respect of the institutional advice market. As we commented in our response[142] to the Market Study Terms of Reference in 2015, investment consultants play a central role in the institutional asset management market and the quality of their advice is likely to be crucial in determining outcomes for institutional investors. Ensuring that this element of the investment value chain works well for institutional investors is therefore highly important.

435. The FCA's analysis of the conflicts of interest that arise in the investment consulting sector addresses important issues. We consider the vertical integration between advisory and fiduciary services as the most serious potential conflict of interest. We are particularly keen that where consultants provide asset management products and services, they compete on a level playing field with asset managers both in terms of regulatory oversight and client scrutiny of their performance.

Extension of regulatory perimeter

436. The IA strongly supports the FCA's proposal to recommend that HM Treasury should bring both the advice provided by investment consultants to institutional investors and the advice provided by EBCs to employers and trustee boards within the regulatory perimeter of the FCA.

437. As the FCA notes, asset allocation decisions are likely to be one of the most important drivers of outcomes for institutional investors[143]. Although trustees make the final decisions on asset allocation (unless they have gone down the full Fiduciary Management route) the asset allocation advice given by consultants is hugely influential.

438. The Myners' review identified as long ago as 2001 that trustees did not devote sufficient resource to asset allocation decisions and it is a concern that that the FCA still finds this to be the case today. This lack of focus means the advice of consultants in this area becomes even more important. Given both the importance and the influence of the consultant's asset allocation advice (and for that matter manager research and selection[144]) it seems an anomaly that such advice is not an FCA-regulated activity.

439. It is also anomalous in light of the fact that asset managers providing multi-asset products are FCA-regulated persons. This is entirely correct and we do not see why consultant advice should

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[141] Tilba, Baddeley and Liao Report, p.85.
[142] 'FCA Asset Management Market Study: Terms of Reference – Comments from The Investment Association', December 2015. Available to download from the IA website.
[143] There is a significant body of academic work on the impact of asset allocation on returns. See 'Setting the Record Straight on Asset Allocation', CFA Institute, February 2012 for a good discussion of the literature.
[144] We note that the FCA states in its MIR for the investment consulting market that *"strategic asset allocation advice provided by investment consultants and the manager research and selection process they undertake can currently be done in a way that is not regulated by the FCA"*.

be treated any differently. Assessing the performance of consultant advice in this area will give institutional investors the same power to hold consultants to account that they currently have in relation to their asset managers. We consider that a clearer articulation of performance by the consultants will facilitate enhanced competition in that market through investors being more informed.

440. The 1995 Pensions Act understandably only requires advisers to pension fund trustees to be regulated where the advice they give is itself regulated advice (i.e. particularised). The issue about the regulation of advice to pension fund trustees is therefore a question about the definition of regulated advice. Principally, our understanding is that this is because the advice does not relate to the merits of buying or selling a particular investment as opposed to the merits of investing in asset classes or sectors.

441. We would expect that the Government would resist removing the need for particularisation from the definition of investment advice. Indeed, the outputs from FAMR include a decision to remove article 53 of the Regulated Activities Order, so narrowing what is regulated. We would agree that merely removing the requirement for particularisation would not be the right approach. Large numbers of conversations and activities across the City of London involve advice, in the broadest sense, about financial instruments which does not involve personal recommendations about particular investments. To treat all of the conversations and activities of the capital markets as regulated activities would be wholly disproportionate.

442. Nevertheless, we do consider that it would be possible to sufficiently frame a regulated activity based upon the fact that the advice is being given to pension fund trustees to meet their requirements under section 36 of the Pensions Act 1995, and other provisions that could be set out. Investment consultants and others who were giving advice in these circumstances would then be regulated. For example, the regulated activity might be "Advising trustees on the question of whether any investment is satisfactory having regard to the matters mentioned in subsection 36 (2) of the Pensions Act 1995 and the principles contained in the statement under section 35."

443. This analysis also applies to the advice that is given by EBCs to trustees and employers in the DC workplace pensions market in relation to the creation of the default investment strategy in these schemes. DC default strategies are typically multi-manager and/or multi-asset solutions, with the EBCs creating their own default strategies by blending external managers' products. The advice provided here seems to us to fall into the same category as more traditional institutional investment advice and we see no case for it not to be regulated. Making this advice a regulated activity will allow the FCA to set performance standards or assessment criteria that trustees and employers will be able to use to hold EBCs to account for the advice they provide.

Gifts and hospitality in the investment consulting sector

444. The FCA discusses in Chapter 8 of the Interim Report the relationship between gifts, hospitality and revenues from asset management groups and the ratings given to them by investment consultants.

445. The value of expenditure on these non-monetary benefits has fallen significantly following the publication of the FCA's inducement guidance in 2014[145] and we expect further falls in future years following the publication of the FCA's thematic review last year[146]. It is our understanding that both managers and consultants have strict policies in this area.

446. However, there is scope for greater clarity and consistency with respect to the overall policy on inducements, with the discussion in the Interim Report suggesting that the institutional market in particular would benefit from this. In that regard we would note that much of the detailed guidance to date has focused on the retail market ((FG14/1) and COBS 2.3.14G - 2.3.15G[147] have tended to be based on intermediary-related business and inducements to intermediaries and IFAs in respect of retail investment business).

447. In contrast, the requirements around inducements in connection with the provision of MiFID services (i.e. institutional asset management) is expressed in COBS 2.3.1R[148] in less detailed terms than for retail investment business. We assume that the policy intention and direction of travel is for the same principles and guidance to apply to both retail and institutional business – this should perhaps be more explicit.

448. Although the FCA has previously stated its view that the existing inducement rules are clear, there still remains a degree of lack of clarity around them. Since the FCA published its thematic review in 2016, the IA has been providing guidance to its members through the creation of a recommended practice guide to assist firms in drawing up inducement policies. The implementation of MiFID II provides an opportunity to clarify the inducement rules and guidance such that there are clear, consistent and unambiguous guidelines for acceptable and non-acceptable practice in terms of inducements and non-monetary benefits for both retail and institutional asset management.

[145] FG14/1 – Supervising retail investment advice: inducements and conflicts of interest, FCA, January 2014
[146] Inducements and conflicts of interest thematic review: key findings, FCA, April 2016
[147] FCA COBS 2.3 Inducements
[148] Ibid.

ANNEXES

ANNEX ONE: TECHNICAL ANALYSIS

1. This Annex provides further background to the discussion in our main response, and particularly Parts One and Two. It includes a detailed technical comment in six key areas:

    - Retail fund market distribution
    - Price trends and clustering
    - Investors' sensitivity to price
    - Industry profitability
    - Fund performance
    - 'Partly active' funds and indicative metrics

2. In this context, we present additional evidence based on IA analysis where relevant.

1. Retail fund market distribution

3. Traditionally there were two avenues into an investment fund for a retail client in the UK: investing directly with the fund manager or investing through intermediaries (financial adviser, wealth manager, private bank). Due to innovation in the industry, and in particular the rise of fund platforms, retail clients can now access funds and investment research more readily and in more ways than ever before.

4. The direct book, i.e. non-advised investors buying directly from fund managers, has been steadily declining in significance since the late 1990s when its market share was around 20%. As at the end of 2016, an estimated 8% of retail sales were made directly while fully advised sales are estimated to account for some 78% of retail sales – see Figure 1.

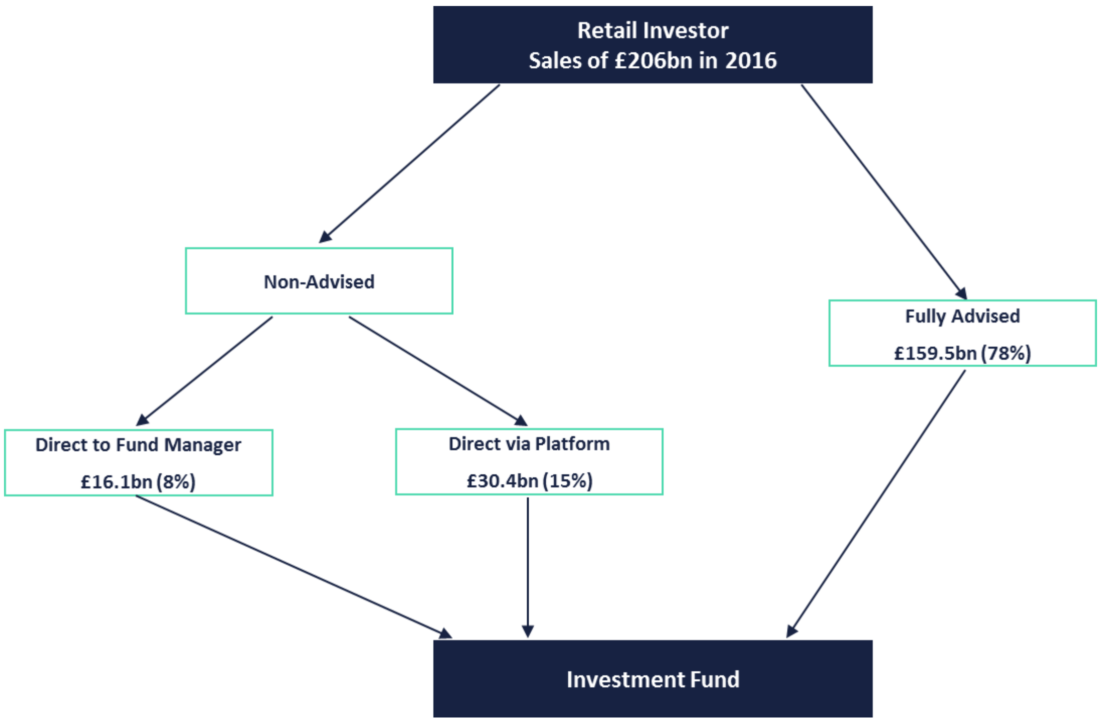
5. The significance of the scale of the advised sales process raises important issues around the dynamics of market competition, given the existence of intermediaries that are driving critical decisions by millions of savers. In this respect, it is important to consider where accountability lies for fund selection and portfolio construction.

6. This in turn highlights the importance of defining different types of investor and the associated buying processes as a way to assess the dynamics of the market. Figure 1 splits the investor universe into three broad approaches, with some investors likely to be using more than one category for different investments:

    - A non-advised investor effectively investing directly with the fund manager. They will not be using an adviser, although decisions may be shaped by influencers in the media or their social/family circle and/or gatekeepers within financial services (see below).
    - A non-advised investor who is not going directly to the fund manager, but neither is fully advised. This kind of approach is likely to be characterised by investors using different forms of fund management platform, possibly with guided architecture and/or a select list of funds based on professional screening.

- An advised investor going to an IFA for financial planning on the basis of which a portfolio of funds is recommended, possibly using outsourced or centralised risk profiling, asset allocation and fund selection tools. This is the largest group accounting for almost 80% of gross retail sales.

Figure 1: Gross retail sales – overall distribution split[149]

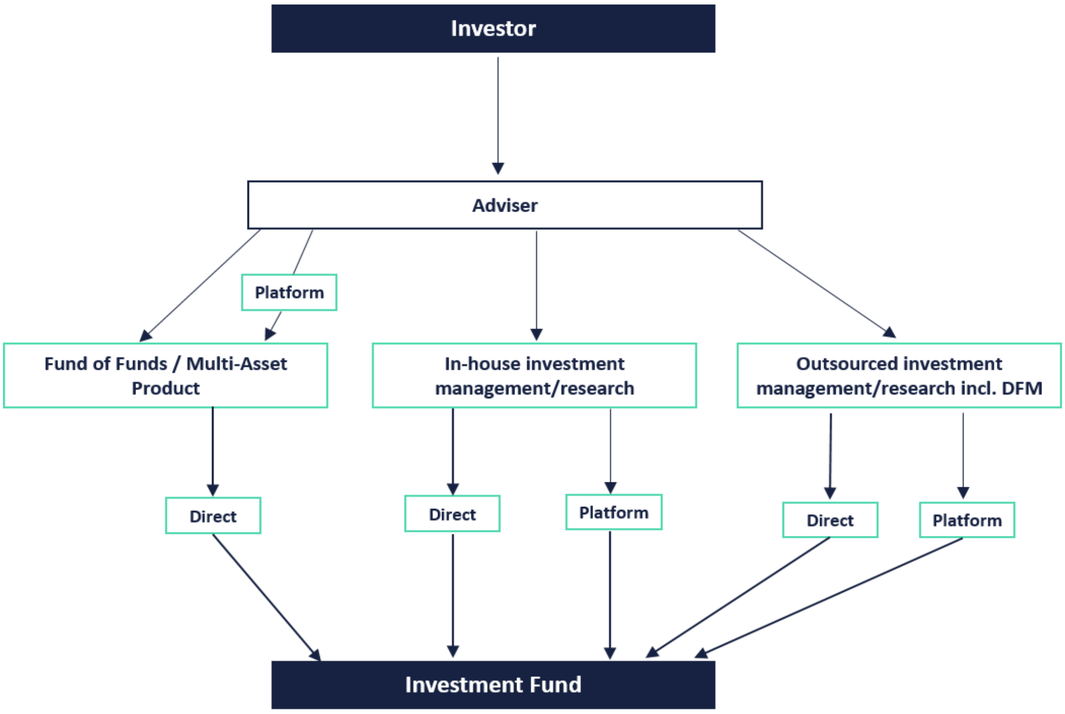


7. Looking in more detail at the fully advised retail sales channel, Figure 2 sets out the different intermediation elements that a retail investor and their adviser may encounter. In this Figure, we show some possible, but by no means all, routes through which an advised investor's money can be channelled to an investment fund.

8. Once the adviser has received instructions from the investor they have three routes for the money, which will depend on the investor's pot-size and the adviser's business structure. An investor with a small pot would likely be directed to an 'off the shelf' multi-asset product and the adviser may use a platform to carry out the investment. An investor with a larger pot could be directed to a bespoke investment management service, which may be operated in-house or outsourced, depending on the adviser's resources. The multi-asset product provider would likely invest directly with the investment fund, whereas the investment management route could be carried out directly with an investment fund or through a platform, again depending on the adviser's business structure. The fee paid by the investor is dependent on the level of service offered by the advisor and levied by the platform, where with each level of intermediation a further cost is experienced.

[149] Gross Sales based on IA data. Direct includes sales through a sales force or tied agents and private client sales of own funds. Platform sales include execution only stockbrokers and 1/3 of total platform sales. The IA estimates that flows through platforms are 1/3 direct to consumer and 2/3 advised.

Figure 2: Advised routes to an investment fund

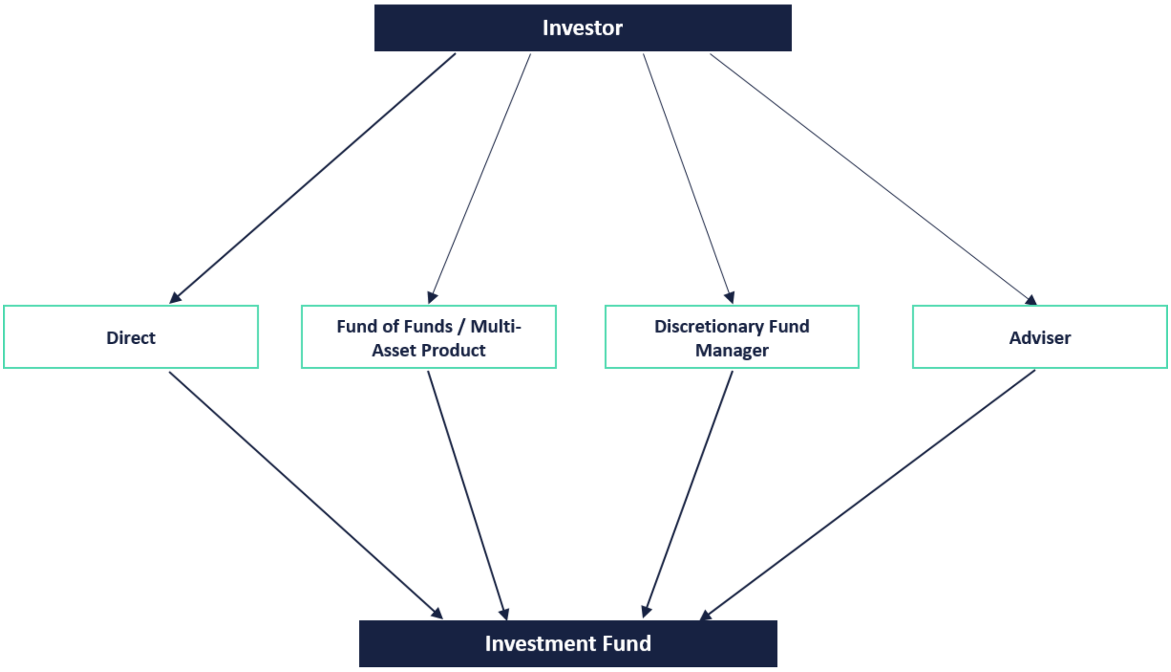


Fund selection and asset allocation

9. A critical point about the intermediation of the relationship between retail investors and underlying fund managers concerns the process of portfolio construction and asset allocation. This matters particularly in the context of a competition study because investors may look to different routes to secure their ultimate goal: building a portfolio of assets.

10. In the direct model, the cost of building an asset allocation or a specific strategy targeting an outcome and selecting particular funds will either fall on the individual investor or, if the investor selects a fund manager offering a multi-asset fund or a specific solution (e.g. for a targeted absolute return fund), the cost of asset allocation will be incorporated in the fund charges. This function could also be fulfilled in different ways, using funds of funds, a discretionary fund manager or adviser. While Figure 3 is a significant simplification of buying processes, it is designed to illustrate that asset allocation can be determined not only by the fund manager but also by the investor, the bespoke service of a discretionary fund manager, or the adviser.

Figure 3: Different approaches to fund selection and asset allocation[150]



11. This implies a fundamental point about competition: many fund managers who asset allocate or build solutions at a fund level are not just competing against each other but against others in the distribution chain. Total charges and costs, and the dynamics of product competition, have to be analysed in this wider context.

Rise of the gatekeeper

12. Beyond the role of the adviser, these examples also highlight the growing significance of different forms of gatekeepers, sitting between the consumer and the fund management company, often alongside (or as part of) the adviser services:

    - Fund and online wealth management platforms, offering a variety of services across the investment market, including best buy lists and model portfolios.
    - Professional fund selectors in a variety of guises: e.g. fund of funds or discretionary fund managers.
    - Fund rating companies, who provide external research on investment fund processes and performance.

13. The combined impact of this gatekeeper community on the dynamics of asset management competition is increasingly relevant, with some research estimating that 70% of fund flows are influenced by gatekeepers and that this percentage is even higher in adverse market conditions.[151] The breadth of the gatekeepers' influence stretches across both the advised and

[150] Within the direct route using a fund of funds, the investor may make the fund selection of a particular fund of funds, but then the fund manager undertakes asset allocation and other strategic decisions regarding the underlying funds.

[151] Fundscape and Graham Bentley, *The Gatekeepers Report*, 2016. A publicly available executive summary can be accessed here.

non-advised retail market. Fund research and information is freely available to non-advised retail investors through platforms and other intermediaries, and Platforum estimates that 40% of IFA assets are subject to outsourced investment research.[152]

14. The important role of advisers and gatekeepers means that the fund selection processes should be examined in the context of the intermediation services that they are providing. This service is increasingly sophisticated and includes a wide range of factors, with many using qualitative and quantitative metrics, such as:

    - Price
    - Performance
    - Investment process and capacity
    - Management team
    - Wider investment culture
    - Approach to risk management

15. This crossover between adviser and gatekeeper creates an additional layer of an informed buying or guiding community that will impact on consumer decision-making and on fund pricing. As long as any potential conflicts of interest in this process are well-managed, the effect of these intermediaries on retail market competition can be positive by helping to create a better informed demand side.

16. This is not to diminish the importance of ensuring that direct customers seeking to make independent, informed decisions are well served. It highlights the fact that the market as a whole is constructed differently to other parts of financial services where there is usually a more direct relationship between providers and customers (e.g. deposit and savings accounts, credit cards etc.).

2. Price trends and clustering

17. The Interim Report's conclusion that there is weak price competition in some areas of the industry touches upon two issues: price dynamics both in terms of trends and clustering, as well as how price sensitive the demand side is.

Price clustering

18. We begin by looking at the finding that *"clustering of prices appears to be a feature of the asset management industry"* which *"becomes more apparent when examining narrower investment categories"*.[153] It is not clear why this is taken as evidence of lack of competition. Indeed in a competitive market, one would expect to see similar prices for similar products, particularly when examining funds within a similar asset class.

19. Using ongoing charges data from Morningstar Direct and Financial Express the IA has looked at both the dispersion and the level of OCF. Our analysis, similar to the FCA analysis, has one key

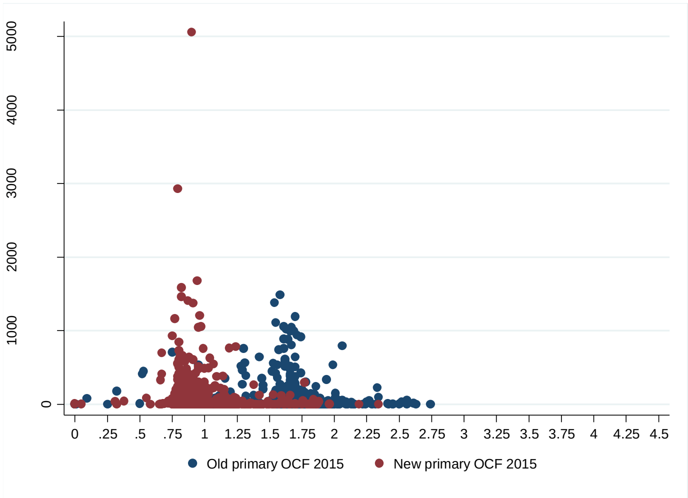
[152] Platforum blog, *DFM assets on platform and the trend to outsourcing*.
[153] Para 6.72, p.112.

limitation in that it focuses on headline charges rather than the effective price investors pay via distributors. This is particularly important in the context of RDR whereby intermediaries (both platforms and advisers) exert pressure on investment charges and secure discounts for investors, which are not reflected here.

20. Looking at the primary share classes available to investors in active equity funds in 2015, we see a wide range of prices with concentration around two points, one between 0.75% and 1% and the other between 1.5% and 1.75% – see Figure 4. Unsurprisingly, the former reflects clean or 'unbundled' post-RDR prices and the latter bundled, pre-RDR prices.

21. There is a degree of clustering in both cases, with 60%[154] of observations for the old primary OCF being between 1.5% and 1.75% and 62%[155] of observations for the new primary being between 0.75% and 1%. Still, these are 25 bps apart and for both bundled and clean share classes about 40% of OCFs are outside these ranges. Moreover, it should be noted that the dispersion seen in prices partly reflects the fact that equity funds as a group include funds with a wide range of objectives that may impact pricing. For example, as we explore further below, funds specialising in domestic equity are typically cheaper than those that specialise in e.g. global and/or emerging equity.

Figure 4: Distribution of OCF against funds under management for old and new primary active equity share classes

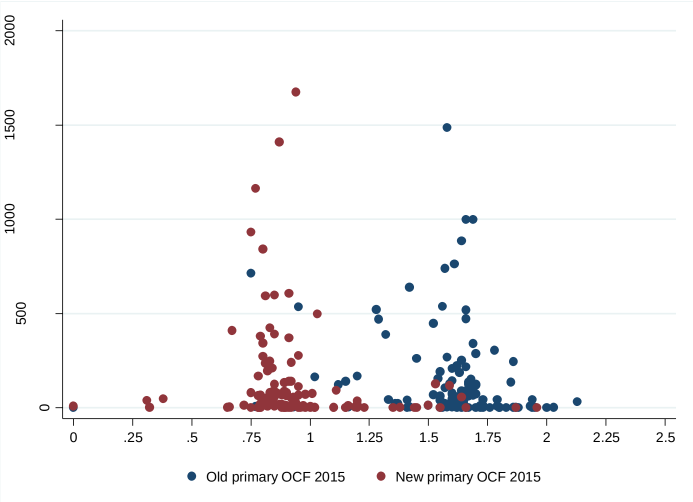


(Source: IA analysis based on Morningstar and Financial Express data)

22. Looking at a narrower investment type, we can make very similar observations for the UK All Companies sector.[156] Figure 5 shows the distribution of OCF in 2015 of primary share classes available to investors and again there is a concentration around two points. We see that 69% of old primary OCF observations are between 1.5% and 1.75% and 72% of the new primary OCF observations are between 0.75% and 1%.

[154] 403 out of 670 observations.
[155] 445 out of 721 observations.
[156] The UK All Companies sector is by far the largest IA equity sector with funds under management of £163bn – twice the size of the second largest IA equity sector, Global, with funds under management of almost £86bn.

Figure 5: Distribution of OCF against funds under management for old and new primary UK All Companies share classes



(Source: IA analysis based on Morningstar and Financial Express data)

23. Our analysis shows that there is a similar degree of clustering for both bundled and clean prices but prices are not identical. We see clustering within a range that is 25bps apart and we also see choice for investors where about a third of UK All Companies funds and almost 40% across all equity funds are outside this range.

24. We would consider that the degree of clustering that we (and the FCA) observe is to be expected within similar types of funds and so we would like to better understand why this is interpreted as a lack of competition rather than the expected outcome of competition, particularly given price trends following RDR that we explore in the following section.

Price trends

25. The Interim Report concluded that *"charges (the OCF) for active funds have not changed significantly over time"*[157] but our analysis shows declining prices (which is actually reflected in Figure 6.14, p.112 of the Interim Report, as well). Table 1 looks at the simple and asset-weighted average OCF of both the old (bundled) and new (clean) primary share classes of active funds across all IA sectors (and asset classes) as well as for the top 10 IA sectors in terms of funds under management as of end 2015. A number of conclusions can be drawn.

26. First, although in some respects this may seem obvious, in the context of the price clustering discussion, it needs to be stressed that prices differ depending on fund type. For example, a Global equities fund typically costs 10 bps more than a UK All Companies fund which itself is about 20 bps more expensive than the average £ Corporate Bond fund. Mixed-asset funds cost more than single asset funds. So there are valid reasons, such as risk, geographical focus, asset allocation etc., why funds of different types have different prices while competition between funds in the same sector (e.g. with similar cost and risk) may result in more similar prices.

27. Second, although the period examined is relatively short as we focus on the post-RDR years, we can already observe a drop in average ongoing charges across all funds with the asset-weighted

[157] Para 6.70, p.111.

average bundled OCF falling by 4 bps and the new clean OCF falling by 7 bps within two years. For clean funds, we also observe a drop in average prices across all the top 10 sectors, except North America.

28. Third, in almost all cases the asset-weighted average price within a sector is consistently lower than the simple average price. This is particularly important in the context of investors' price sensitivity and awareness as it indicates that more money is invested in cheaper share classes.

Table 1: Average OCF across old and new primary share classes of active funds, 2013-2015[158]

		Old primary 'bundled' OCF		New primary 'clean' OCF	
		Simple Average	Weighted Average	Simple Average	Weighted Average
All	2013	1.66	1.60	1.07	0.99
	2014	1.66	1.60	1.06	0.94
	2015	1.64	1.56	1.04	0.92
UK All Cos	2013	1.61	1.57	0.94	0.90
	2014	1.60	1.59	0.96	0.87
	2015	1.59	1.53	0.95	0.87
Global	2013	1.72	1.72	1.14	1.21
	2014	1.71	1.74	1.08	0.98
	2015	1.65	1.70	1.11	0.98
TAR	2013	1.65	1.58	1.07	0.94
	2014	1.58	1.47	1.10	0.95
	2015	1.55	1.32	1.04	0.90
UK Equity Income	2013	1.63	1.55	0.98	0.85
	2014	1.60	1.57	0.96	0.85
	2015	1.59	1.58	0.93	0.81
£ Corporate Bond	2013	1.04	1.03	0.62	0.68
	2014	1.04	1.06	0.61	0.67
	2015	1.01	0.99	0.61	0.65
Mixed 40-85%	2013	1.78	1.85	1.23	1.23
	2014	1.86	1.83	1.23	1.08
	2015	1.79	1.77	1.23	1.08
Europe excl. UK	2013	1.71	1.70	0.99	0.92
	2014	1.67	1.68	0.96	0.91
	2015	1.65	1.62	0.95	0.90
Mixed 20-60%	2013	1.86	1.86	1.23	1.15
	2014	1.86	1.84	1.19	1.06
	2015	1.85	1.80	1.18	1.07
Specialist	2013	1.81	1.68	1.20	0.97
	2014	1.80	1.68	1.17	0.96
	2015	1.79	1.65	1.15	0.94
North America	2013	1.63	1.60	0.94	0.88
	2014	1.61	1.55	0.94	0.92
	2015	1.63	1.56	0.94	0.90

(Source: OCF data from Morningstar and Financial Express. Share class funds under management from IA internal database.)

[158] Share class funds under management were used for the asset-weighted average calculations.

29. As highlighted in Part Two of our response, the impact of RDR has not yet fully played out, and therefore, further decreases in average prices resulting from increased competitive pressure would be expected over the coming years.

3. Investors' sensitivity to price

30. This section provides an overview of and comments on the Interim Report findings on investors' awareness of and sensitivity to price that feed into the conclusion that there is weak price competition. The findings relate to three pieces of work:

- NMG research on non-advised retail investors which included qualitative interviews and a quantitative survey as described in Annex 3 of the Interim Report.[159]
- An econometric analysis of the drivers of retail fund flows with a specific focus on the effect of platforms' best buy lists as described in Annex 4 of the Interim Report.
- An online survey of institutional investors (with 89 respondents) as described in Annex 5 of the Interim Report.

31. A number of conclusions are drawn from this work which we explore separately.

Quantitative evidence

32. One important finding relates to the factors that drive investor choice from which two things are concluded. The first conclusion is that *"a key focus for retail investors and, to some extent, institutional investors when choosing between asset managers is past performance"*.[160] The second conclusion is that *"the evidence on investor focus on charges is mixed. There is increasing attention among institutional investors to the level of charges that they pay, as reflected in the demand for greater transparency around costs … On the retail side however, around half of the investors in our survey were not aware they were paying fund charges."*[161]

33. It is clear from Figures 4.2, 4.4 and 4.5 in the Interim Report that three factors are important for both retail and institutional investors: price, performance and reputation. One reason why it may appear that retail investors are less sensitive to price than institutional investors are, relates to presentation of survey results. Specifically, we note that although the questions addressing the factors that are important in choosing funds for retail investors and when selecting asset managers for institutional investors were similar in content they were different in format.[162] Retail investors were presented with a 'select all that apply' question whereas institutional investors rated different factors. This is important when drawing conclusions because respondents to the institutional investor questionnaire had to consider not only absolute but also relative importance – hence the final presentation in a ranking – while retail investors were able to select multiple factors (all given equal weight) with the results presented in percentages.

[159] Also note Appendix 1 to the Interim Report has the NMG Consumer Survey Technical Report which describes in detail the methodology and the questions for both the interviews and the quantitative survey.
[160] Para 1.35, p.17.
[161] Para 1.38, p.18.
[162] See Question 28, p.33, NMG Consumer Survey Technical Report for retail investors and Figure 14, pp.15-16 in Annex 5 of the Interim Report for institutional investors.

34. Charges still received the highest percentage across all factors for retail investors (45% of respondents considered that charges were influential in their choice of fund). However, it is possible that if retail investors had been presented with a ranking question, as institutional investors were, the evidence on how important charges are may well be even more similar.

35. Other evidence from the NMG Consumer Research also points to retail investors being sensitive to price, for example the finding that 77% looked at charges when making their investment decision[163] and 72% of those identified ongoing fund charges as the type of charges they looked at.[164] This indicates a price awareness that is at odds with the assertion that half of investors in the sample were not aware that they were paying fund charges. There are a number of issues around this assertion.

36. First, the NMG questionnaire shows that this is based on a question *"Do you pay fund charges on your most recent investment product"* that was asked for people with different investment products including funds, stocks & shares ISAs, personal pensions and income drawdown plans. Most respondents to this survey held ISAs, followed by personal pensions, then funds and few held income drawdown plans and although it is noted that *"many fund investors hold a number of different types of fund investment products"*[165] respondents were asked that question in reference to their most recent product only.[166] As such, we expect that there would be a difference in awareness of fund charges between respondents that answered this question in regards to funds and those who answered it in regards to wrappers.

37. Second, it is possible that the way the question was asked could have created some confusion for respondents due to the additional note *"these are charges related to your fund(s), not charges related to your product"*[167]. There is research suggesting that there is confusion among non-advised investors as to the composition of wrappers which may have led some to respond that they do not pay fund charges.[168] At the same time, as it was stated that it was not related to their product, respondents may have answered "No" even if they were aware of the underlying components of the price they were paying for the wrapper.

38. Third, and more importantly, some pension and ISA providers charge a single price for the wrapper that includes the charges of the underlying funds. Hence, investors in those products would be correct to state that they do not pay a charge separately from their product charge.

39. Fourth, we note that the consumer survey is based on direct investors whereas the majority of the retail market is intermediated. As such, more clarity is needed about the extent to which the results of this survey can be generalised for the entire retail market, particularly as it would be

[163] Annex 3, Figure 16, p.41.
[164] Annex 3, Figure 17, p.41.
[165] Annex 3, para 59, p.30, NMG Consumer Survey Technical Report.
[166] As per Question 14, p.28,
[167] See Question 30, p.34, NMG Consumer Survey Technical Report.
[168] NMG research on non-advised retail investors suggests there is "*extremely low awareness that individual funds were contained within products such as stocks and shares ISAs"* and it was noted that "*the majority were under the impression that it was a product rather than a wrapper and did not know how risk was spread across the individual funds or even that they could have selected these themselves."* For further details, please see NMG Consulting, *The motivations, needs and drivers of non-advised investors*, June 2014.

expected that advisors would know whether their clients will pay fund charges for the various products they recommend.

Qualitative evidence

40. The Interim Report states that respondents to their qualitative research "*typically did not mention charges unless they were prompted*"[169] and Annex 3 reports that interviewees *"rarely expressed the unprompted view that fund fees were an important consideration in fund selection; however, when presented with the explicit choice, many respondents in the quantitative survey stated that fund fees were an important consideration in fund selection"*.[170]

41. Specifically in the context of fund selection, Annex 3 notes that the key criteria are risk profile and performance while charges, active/passive management and the fund's lifecycle are *"rarely considered"*.[171] The discussion guide for the interviewers as provided by NMG however shows that when covering the topic of 'choice sets' interviewers were presented with separate questions about riskiness, investment horizon, liquidity, past performance, range of choice and active/passive management but not about price.[172] This raises the question whether interviewees focused more on these factors rather than price because they were prompted in regards to the former but not in regards to the latter.

42. Fund charges were discussed at a later point but the interview questions were more focused on the exact amounts of charges rather than awareness in general or consideration of charges in fund selection.[173] Even so, although most respondents could not provide the exact amount they were paying, they *"knew the charges when they made the investment"* and charges of 0.5% to 1% were *"commonly cited"*.[174] This would indicate that interviewees had both a recollection of the charges they were paying and took charges into account when selecting a fund. This also corresponds to charges being one of the most mentioned drivers of value for money.[175]

43. There is additional evidence throughout the qualitative research to indicate a stronger consideration of charges than suggested. For example, the top two factors that highly engaged investors consider when deciding provider or platform were choice of investments and charges.[176] At the same time, high charges were a key reason why investors switch funds.[177] So taken together the survey and interview evidence would suggest a higher degree of awareness and consideration of charges than what has been presented.

44. As a final comment, there is a question as to how comparable the results of the qualitative interviews and the quantitative survey are given that the former focussed on 40 respondents whilst the latter involved 2,500 direct investors.[178]

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[169] Para 4.28, p.49.
[170] Annex 3, footnote 2, p.5.
[171] Annex 3, para 16, p.7.
[172] See Part 3.3, p.13, NMG Consumer Survey Technical Report.
[173] See Part 4, p.14, NMG Consumer Survey Technical Report.
[174] Annex 3, para 43, pp.24-25.
[175] Annex 3, para 45, p.26.
[176] Annex 3, para 28, p.18.
[177] Annex 3, para 40, p.23.
[178] Annex 3, paras 8-9, p.4.

Econometric evidence

45. The econometric analysis in Annex 4 to the Interim Report would suggest a degree of price sensitivity among retail investors. The focus is on the connection between a share class featuring on a platform best buy list and fund flows in and out of that share class and factors such as performance, fees, and return volatility are used as control variables. The regression results indicate that fee rank (which is the percentile fee rank of each share class in relation to other share classes in the same Morningstar Category) is negative and statistically significant across a range of specifications.[179]

46. The Interim Report concludes that *"more expensive share classes experience relative falls in total net assets. This suggests that some investors respond to prices in the UK asset management industry. However, this may be restricted to those share classes that have above average prices."*[180] The regression results indicate that the latter statement is unlikely to be accurate as the top half fee rank indicator variable is insignificant throughout all regression specifications. However, we would argue that the analysis shows a high degree of price sensitivity and we would welcome further analysis in this area.

4. Industry profitability

47. This section discusses the Interim Report analysis of the profitability of the asset management industry and the conclusion that firms across the sector earn high and stable profits. We cover first the points relating to the costs of capital calculations and then the wider discussion around the level of operating margins in the industry and how this compares to other sectors.

Cost of capital

48. The main finding regarding cost of capital is that using a range of different assumptions, the cost of capital would be expected to be in the range of 5.5-8.5%[181] whilst the estimated ROCE is 12.7%.[182] We note that little detail is provided in Annex 8 regarding the calculation of the 5.5-8.5% range and we would welcome more clarity in regards to the following statements:

   - That WACC involves an estimation for *"a hypothetical UK asset manager over the period 2010-2015"* and that *"Market parameters (risk free rate, equity risk premium) are based on the UK market. Beta estimates are taken from firms within our sample for the relevant period."*[183]
   - That the analysis has considered *"a range of values for each variable based on different assumptions"*.[184]

49. Given the significance of this section, we would welcome more information on the underlying calculations as well as some clarity in regards to sample composition and the extent to which a

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[179] As presented in Annex 4, Table 2, p.12.
[180] Annex 4, para 56, p.12.
[181] Para 6.91, p.118.
[182] Para 6.93, p.119.
[183] Annex 8, footnote 9, p.14.
[184] Annex 8, para 54, p.14.

sample of 13 firms would be representative of the industry. The lack of detail provided regarding the underlying calculations means that it is not possible for the IA to assess the FCA's approach.

Return on capital

50. We note that the estimated return on capital of 12.7% is based on two key assumptions: an adjustment that treats frontline bonuses as profits and a 2.6 adjustment to the value of equity reflecting measures of goodwill. We believe that the reasons for the treatment of bonuses as profit requires further elaboration and justification, given the heavy dependency of asset management firms on human capital that is otherwise highly mobile both within the sector and across financial services in general. The payment of bonuses could be considered as entirely appropriate given a desire for an alignment of incentives between client delivery and asset manager remuneration.

51. The treatment of salary and bonuses potentially changes significantly the findings regarding excess profit, particularly when taken in combination with market-referenced goodwill adjustments that the FCA has cited. We estimate that using an unadjusted operating margin of approximately 37%[185] and a multiplier of 3.2[186] would result in a ROCE of around 8.7% which is not much higher than the upper bound of the 5.5-8.5% range (which itself would need to be justified by reference to its assumptions). This example illustrates that there is a considerable range of ROCE values depending on a number of assumptions, and we would expect a presentation that reflected this: i.e. a range, particularly given the proximity of the upper bound of the FCA's return on capital estimation with a return on capital result that combined conventional profitability measures with market-referenced data.

Operating margins

52. The main finding regarding the levels of operating margin was that firms *"have consistently earned substantial profits … with an average profit margin of 36%"*.[187] IA analysis of the average revenue and operating costs amongst the IA membership indicates that average operating margins are around 35%.[188] The Interim Report states that *"average operating profitability … is also growing over time"*[189] but IA analysis points to a fairly stable, rather than growing, average margin with noticeable declines following the 2008 crisis and a slight decline in 2012. These observations are mirrored in independent analysis.[190]

53. Even so, the average operating margin hides a considerable degree of variability within the industry both across firms and time. Considering the issue of cyclicality, the Interim Report notes that firms have suggested that business is cyclical whereby assets fluctuate with market movements but concludes that *"whilst this may be true for certain specialist asset managers, invested in one set of markets, it seems less likely to be the case for firms that are diversified*

[185] As per Annex 8, Figure 4, p.10.
[186] As per Annex 8, para 59, p.15.
[187] Para 1.21, p.14.
[188] The Investment Association, *Asset Management in the UK 2015-2016*, p.78.
[189] Annex 8, para 34, p.10.
[190] See, in particular, McKinsey, *Asset Management Survey*.

globally across many markets".[191] Although the degree of business model diversification will undoubtedly affect profitability, we note that what was distinctive about the 2008 crisis was its global reach given the high degree of correlation across financial markets. This was reflected in strong falls in operating margins.

54. Moreover, further assertions are made that would benefit from further evidence. First, it is stated that *"in the event of a downturn asset managers will be able to trim costs to at least 2010 levels in order to maintain profitability"*[192] which assumes that there are no changes to cost over time. In the context of continuous regulatory change and the compliance cost connected to it, this seems unlikely. Second it is assumed that *"any future downturn would need to be sustained and prolonged for firms to become unprofitable overall in the near future"*.[193] We would welcome further clarity as to how this has been derived.

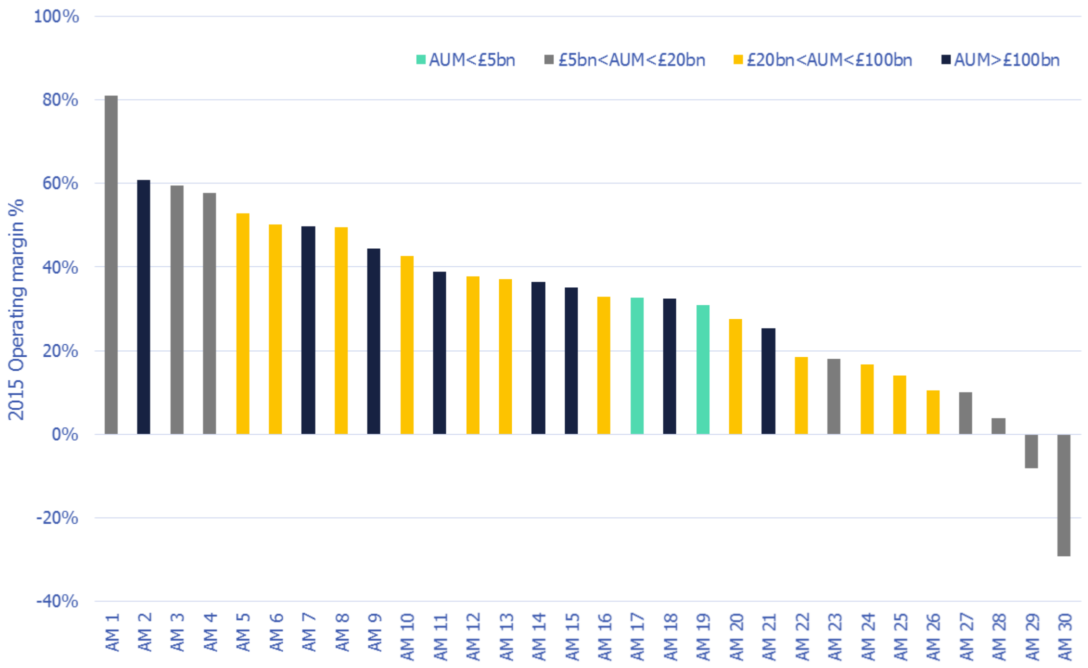
55. Considering variability across firms, using data from the IA Asset Management Survey, we examined the operating margins of 30 firms for which we have information in each year between 2013 and 2015.[194] These firms varied in size with some having more than £100bn in assets under management while others were boutique firms with less than £5bn in assets. In 2015, the firms in our sample had a total of £3.3trn in assets under management,[195] with the top ten firms accounting for 81% of this with assets of £2.7trn.

56. Figure 6 shows the operating margins for 2015 in descending order while firms have been anonymised and colour-coded to indicate their size. It is clear that there is a wide range of margins from almost -30% to 81%, with nine firms having a margin below 20%. There is also considerable variability in terms of size, where the largest firms had margins from 25% to 60% whilst smaller firms had margins starting from negative numbers up to the sample maximum of 81%. This is in contrast to the finding that *"profit is correlated with AUM"*.[196] This could relate to differences in sample composition as our sample includes several medium and smaller firms whilst for the Interim Report sample *"firms were selected primarily due to scale"* and an undisclosed number of smaller firms were included.[197]

57. This is not a picture showing consistent profitability across the spectrum. Figure 7 shows that there is also a considerable degree of variability in year-to-year margins within each firm. Half the firms in our sample saw their margins in 2015 decrease from 2014 and also half had lower margins in 2015 than in 2013. About a quarter of firms saw a change of more than 10 percentage points in margin from 2014 to 2015. There are still more extreme cases within each year, for example, we see that the firm with the second lowest (negative) margin in 2015 had as much as 28 percentage points higher margins in 2014 and 2013.

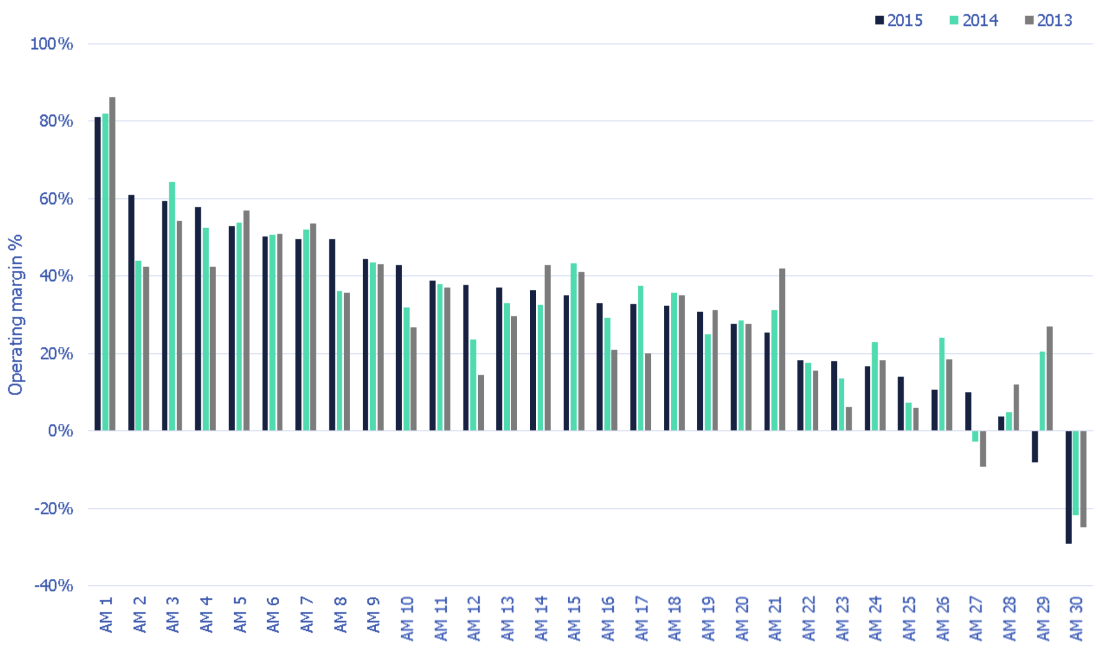
[191] Annex 8, para 39, p.11.
[192] Ibid.
[193] Annex 8, para 40, p.11.
[194] We calculate operating margin as net revenue (before amortisation and exceptional items and excluding any finance expenses) less costs (fees retained after payment of any commission or sales revenue retained by third parties) divided by net revenue.
[195] This amounts to 59% of IA members' assets under management.
[196] Para 6.89, p.117.
[197] Annex 8, para 4, p.2.

Figure 6: Operating margin in 2015



(Source: IA data from the Investment Association Asset Management Survey)

Figure 7: Operating margin in 2013-2015



(Source: IA data from the Investment Association Asset Management Survey)

58. Another key Interim Report finding relates to the asset management industry's profitability compared to that of other industry groups as presented in Figure 6.21[198] which draws from the analysis in Annex 8 where it is concluded that *"relative to other industry groups, operating margins for asset managers in our sample appear to be high"*.[199]

59. Although we note that five industry groups[200] have similar (and one of these higher) margins, an important question relates to the actual comparability between other industry groups and the asset management industry. The description of the analysis in Annex 8 implies that the latter is based on the FCA sample that covers the years 2010-2015, whilst the title of Figure 6.21 (and that of Figure 5 in Annex 8) indicates that the margins of the other industry groups are calculated over 2006-2015, i.e. a period that includes the economic downturn during the 2008 financial crisis. This could affect the comparability across industry groups and we would welcome further clarity on whether the asset management industry margin in that figure covers the same time period as that for the other industry groups.

60. Furthermore, it is unclear what conclusions can be drawn by a comparison of operating margins across sectors when the FCA has acknowledged the impact of high intangible assets in the asset management sector and given that this comparison does not take into account other factors such as capital intensity and risk.

5. Fund performance

61. This section looks at the overall analysis on fund performance, including aspects such as active funds' ability to outperform, the relationship between performance and fees, persistence and comparability. However, before exploring the Interim Report findings in detail there are two significant points to be made that affect the context of any performance analysis.

62. First, there is a longstanding view that all *asset manager* activity is a zero sum game – something that is reflected in several places throughout the Interim Report.[201] Whist it is true that all *investor activity* in the market will result in the 'market return', asset managers do not constitute 100% of the market. For example, IA's members' UK equity holdings account for about 31% of the UK domestic market capitalisation.[202] Moreover, IA analysis of shareownership across FTSE 100 constituents in 2014 indicated that IA members owned on average 34% while 'traditional investment managers' worldwide (including the UK) owned on average 55%.[203]

63. As such, asset managers are only one group of market participants, the others being hedge funds, investment banks, the state, the general public etc. and so we would argue that all asset manager activity is not a zero sum game and that there can be other investors that are on the other side of the equation. Hence it would be possible for asset managers as a whole to outperform the market (or underperform it). The possibility of *"other investors … collectively underperforming"* is viewed to be a possible explanation for the outperformance found in the

[198] pp.117-118.
[199] Annex 8, Figure 5, p.11.
[200] These are Banking, Institutional Financial Services, Metals & Mining, Real Estate, and Software.
[201] For example, paras 6.30 and 6.32, p.97
[202] The Investment Association, *Asset Management in the UK 2015-2016*.
[203] Averages weighted by company market capitalisation. Source: IA analysis based on Capital IQ data.

institutional outcomes analysis in Annex 6 to the Interim Report.[204] The implication of the data presented from FCA analysis of retail fund performance is that the same phenomenon is taking place in this market as well, given that average returns net of all fees and costs are greater than those of the benchmark net of all fees and costs (see detailed discussion below).

64. The second point relates to how performance is actually assessed and it seems that throughout the FCA analysis, the delivery (and indeed the definition) of active funds seems to be determined only in terms of performance relative to a benchmark. Simplifying active management down to outperformance of a benchmark has implications for the connection between findings and remedies. We note that key findings including fund performance and the analysis on 'partly active' funds focus on equity funds. What is very distinctive about equity funds is that they can fairly easily be compared against an index. This is not necessarily the case for the rest of the funds industry if one considers funds that cannot be meaningfully benchmarked, funds where the benchmark is a composite, or funds where a passive strategy is not really feasible, for example property funds.

65. Clarity of objectives and delivery against objectives is important but an objective may not necessarily involve a benchmark. At the same time, there are different shades of 'active' and looking at specific metrics that require a benchmark for their calculation would fail to address a large part of the active funds market. As such, an analysis focusing mainly on outperformance against a benchmark runs the risk of creating a disconnect between key findings that relate to only part of the market and remedies that will be applied across the entire market.

Active versus passive

66. The FCA has looked at investor outcomes and concluded that *"actively managed investments do not outperform their benchmark after costs. Funds which are available to retail investors underperform their benchmarks after costs – while products available to pension schemes and other institutional investors achieve returns that are not significantly above the benchmark."*[205] However, the evidence presented in the Interim Report would suggest otherwise.

67. First, we would argue that the comparison between retail and institutional outcomes is not as straightforward as it may seem. As we discuss in Part Seven of our response, segregated mandates involve bespoke arrangements between asset managers and institutional investors whereby both objective and fees are negotiated on a client-by-client basis. This would affect the comparability of performance net of fees, given the varying fee arrangements, but also gross of fees as the objectives can encompass many factors beyond achieving a certain level of return (e.g. they may involve maintaining specific funding levels). Even so, institutional investors may well buy into pooled funds, which would then mean that any assessment of fund performance would reflect outcomes for both retail and institutional clients. As such, we would like to better understand how outcomes for retail investors have been distinguished from outcomes for institutional investors as well as how different fee arrangements within mandates have been taken into account.

[204] Annex 6, para 85, p.18.
[205] Para 1.25, p.15.

68. Focusing on the analysis of retail funds as presented in Figure 6.1, a number of questions are raised. The FCA's methodology looks at fund performance for both clean and bundled share classes, then only for bundled share classes and then for clean and bundled together whereby the clean share classes' returns are adjusted to include a *"representative core platform charge of 0.375 per cent"*.[206]

69. Given the structural change brought about by RDR, we recognise the technical challenges in assessing fund performance over a period that covers both pre- and post-RDR years. However, as we discuss in Part Two of our response, an accurate assessment of how fund managers add value would involve measuring performance against the cost of investment, i.e. the cost for which fund managers are responsible and not total cost of ownership that includes the costs of advice and distribution – although the latter remains relevant for consumer outcomes. In this context, we argue that instead of adjusting clean share classes to turn them into bundled,[207] a more appropriate methodology would have been to adjust the bundled share classes to turn them into clean.

70. Moreover, we note that the FCA methodology involves an active vs. passive fund comparison whereby funds across different asset classes are put together. It is stated that "*comparing the performance of these active and passive funds may not be a like-for-like comparison. This is because passive funds are more likely to be concentrated in a smaller number of equity categories than active funds."*[208] This is again presented as a potential caveat to the performance analysis at a later point: "*on average (on both a frequency and money-weighted basis) active and passive funds achieved similar net returns over the 2003-2015 period as shown in Figure 6.1. However, as discussed in paragraph 6.27, this may not be a like-for-like comparison.*"[209]

71. Looking at the number of funds available across all IA sectors (and asset classes) we find that approximately 75% of passive funds are equity funds and that this proportion is higher the further into the past we look – for example equity funds represented 84% of available passive funds in 2010. In contrast, equity funds have represented only 40% of active funds throughout 2010-2015. This means that the comparison in the top half of Figure 6.1 is not a like-for-like comparison as it compares active funds from a mix of asset classes to passive funds that are predominantly equity. And more importantly, to the extent that non-equity asset classes performed less well than equity markets in general (e.g. because they involved lower levels of risk exposure), this is an unfair comparison. [210]

72. Where the active and passive samples are more comparable in the bottom half of Figure 6.1 that looks only at equity funds, the Interim Report findings point to an annualised asset-weighted average outperformance of approximately 36 basis points and this includes funds on a bundled fees basis over 2003-2015. And there may still be meaningful differences in asset mix and risk

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[206] Para 6.25, p.96.
[207] In which case the adjustment would need to take into account not only platform (i.e. distribution) costs but also costs for advice.
[208] Para 6.27, p.96.
[209] Para 6.34, p.98.
[210] This is also reflected in the numbers in Figure 6.1 where monthly net returns of mixed passive funds are almost identical to those of passive equity funds, while returns of mixed active funds are noticeably lower than those of equity active funds.

exposure within the very broad category of 'equities' as between the typical passive and typical active fund.

73. We replicated the analysis across new primary 'clean' share classes over 2013-2015 for completeness and the results are presented in Table 2, clearly showing that even without controlling fully for the asset class mix, active funds have outperformed their benchmarks on both a simple and an asset-weighted average basis.

Table 2: Net returns over the benchmark for clean share classes 2013-2015

			Clean Share Classes 2013 - 2015	
			Monthly	**Annualised**
Equity, Fixed Income, Allocation, Alternative	Active	Simple Average	0.08	0.96
		Weighted Average	0.16	1.93
	Passive	Simple Average	-0.03	-0.35
		Weighted Average	-0.02	-0.20
Equity	Active	Simple Average	0.11	1.34
		Weighted Average	0.19	2.30
	Passive	Simple Average	-0.03	-0.37
		Weighted Average	-0.02	-0.19

(Source: Monthly net returns over the benchmark from Morningstar. Share class funds under management for the weighted average calculation from IA internal database.)

74. The Interim Report finding that active equity funds can outperform their benchmarks net of bundled fees (as per Figure 6.1), is not the only evidence that fund managers can deliver more on top of costs of advice and distribution. IA work has also shown that fund managers can deliver fund returns above their benchmarks net of all ongoing charges including advice and distribution.[211]

75. It should be noted that the IA analysis was free of survivorship bias as we analysed the performance across both open and closed funds [212] and the FCA analysis for Figure 6.1 has *"considered share classes in the Morningstar dataset which had existed for all, or any part, of the period 2003-15"*.[213]

76. The above evidence, including those from the Interim Report, challenges the conclusion that *"[on average] active funds underperformed their benchmarks after charges"*.[214] It also challenges the assumption that active and passive funds produce the same outcomes – a key assumption behind Figure 6.2 as well as for the analysis for Figure 1.2 which concluded that investors in passive funds would earn more than if they were invested in active funds.[215]

[211] The Investment Association, *Investment costs and performance: empirical evidence of UK fund industry delivery*, August 2016.
[212] Ibid, p.7.
[213] Para 6.24, p.96.
[214] Para 6.23, p.96.
[215] Para 1.5, p.8.

Fees versus returns

77. Another point that the Interim Report covers is the relationship between price and performance. The academic evidence presented was US-focused and the FCA carried out separate analysis of the median net and gross monthly returns of active share classes that are benchmarked against the FTSE All Share. Given the findings as presented in Figure 6.18 it is concluded that *"while there is no clear overall relationship between price and performance, on average the cheapest funds generated higher gross returns, and higher net returns, than the most expensive funds"*.[216]

78. Interestingly, what Figure 6.18 shows is that the second most expensive group of share classes (fourth quintile) delivered the highest gross and net returns for both bundled and clean share classes. Moreover, it is clear that although the cheapest quintile did slightly better than the most expensive quintile, it still has the second lowest gross and net returns throughout. This indicates that low fees will not guarantee high returns – on the contrary, low fees seem to be connected with the second worst outcomes. So the statement that the cheapest funds generated higher returns than the most expensive funds may be a misleading description as there is no linear relationship between fees and returns.[217]

Performance persistence

79. On the issue of performance persistence amongst UK funds, we note that the results in academic literature as presented in Figure 6.7 are somewhat mixed as all four papers find some evidence of both positive and negative performance persistence. This work covered samples that are largely outdated (for example, the most recent paper by Cuthbertson et al. covers the period 1976-2002) but more recent S&P analysis on US equity funds (Figure 6.9) and GBP-denominated European equity funds (Figure 6.8) is also referenced.

80. Assuming that the US evidence is out of scope for the UK market and focusing on UK funds, we note that the S&P research[218] compares the performance of funds across Europe to S&P indices (instead of the funds' reference benchmarks) and tries to capture the proportion of funds that underperform the assigned S&P index over one, three, five and ten years. As such, these results indicate how many funds out- or underperform an S&P index over different time horizons rather than the proportion of funds that out- or underperform in all periods and so they are not indicative of persistence per se.

81. We would argue that the comparison of UK funds to S&P indices is inappropriate as these are not widely used as reference benchmarks. Namely, across 4472 surviving and closed GBP-denominated funds that are classified within the IA sectors, only 111 have an S&P index as a reference benchmark and the majority of these (86%) are classified within the North America and North America Smaller companies sectors. Similarly, if we look at the 3144 surviving GBP-denominated funds, only 76 are benchmarked against an S&P index and 65 of those are within North America sectors.

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[216] Para 6.83, p.115.

[217] The IA would also welcome clarification on Figure 6.18 since the difference between gross and net returns (a measure of fees) appears to be consistent with ordering in quintiles for bundled funds but not for clean funds.

[218] S&P Dow Jones Indices, *SPIVA European Scorecard*, Year-End 2015.

82. As such, Figure 6.8 does not present the percentage of funds that underperformed their benchmarks but rather funds that underperformed S&P indices and the evidence above indicates that it would be more appropriate to consider performance against the funds' actual reference benchmarks.

83. As an additional note, the Interim Report states that these results *"potentially underestimate the extent of underperformance as they do not capture the funds that have closed or have been merged into other funds due to poor performance"*. [219] However, S&P note that they make a survivorship bias correction: *"SPIVA Scorecards account for the entire opportunity set—not just the survivors—thereby eliminating survivorship bias"*.

84. Still, FCA analysis as presented in Figure 6.10 that covers the period between 2006 and 2015 does point to performance persistence. It is argued that as 11.4% of funds that were in the bottom quartile of performance in 2005-2010 continued to be in the bottom quartile in 2011-2015 there is *"evidence of relative poor performance persistence"*.[220] At the same time that Figure shows that 24.4% of funds that were in the top quartile in 2005-2010 continued to be in the top quartile in 2011-2015. This is higher than the proportion of top quartile funds that end up in the other three quartiles. Furthermore, the greater proportion of poor performing funds that are closed is also indicative of a competitive market since poor funds are forced to exit.

Performance comparability in the context of IA sector classification

85. In the discussion on the use of benchmarks, Paragraph 4.43 (page 54) notes that *"readily-available and recognisable benchmarks … are regularly used in fund documentation and third party comparisons. Though such a benchmark may capture some part of a fund's investment strategy, it may not accurately reflect its overall investment strategy and associated risks. For example, the IA sector categorisation allows funds to invest up to 20% of their assets outside the primary asset class specified in the sector category. This means that funds within the same IA sector category may hold a significant share of their assets in different markets, and so be exposed to different market risks. Therefore past performance, when viewed against these imperfect benchmarks, such as peer group or market benchmarks, may not reflect the fund manager's ability to add value through asset selection"*.[221]

86. The main purpose of having the sector classification system is for investors to know that when they invest in an IA classified fund they will get significant exposure to the asset class as described in the sector's definition. The minimum exposure threshold for classification within an IA sector is in almost all cases 80% while the allocation for the remaining 20% is discretionary, allowing the manager flexibility to deal with issues like liquidity, unexpected flows, corporate actions etc.

87. The IA sector classification system provides freedom in respect of investment in the non-core element of the definition – however, asset managers are responsible to ensure that the

[219] Para 6.48, p.104.
[220] Para 6.52, p.106.
[221] Para 4.43, p.54.

investment strategy adopted by the fund is transparent to the end investor, appropriate to deliver on the fund objective and takes account of TCF obligations.

88. Moreover, the IA sectors framework is built on the basis that it is preferable for a retail investor to have a manageable number of groupings standardised across the industry rather than lots of microcosms (Source: AUTIF Year Book 1999). The 80% minimum exposure to an asset class promotes this. More detailed definitions or granular sectors could lead to more movement of funds across them as the market environment changes which would only lead to confusion for retail investors.

89. Having at least 80% of the portfolio invested in the asset class described in the sector definition not only ensures that a benchmark captures the largest share (and not just part) of the fund's investment strategy, but also that there is a reasonable degree of comparability across funds within the same sector.

90. Based on Morningstar data, we examined equity funds' exposure to their respective sector asset class. Table 3 shows that in November 2016[222], average and median exposure was close to or over 90% – well above the 80% threshold – and in most cases over three quarters of the funds had over 85% exposure to their asset class.

Table 3: Asset class exposure for IA equity sectors, as of November 2016

		Exposure to sector asset class (%)		Percentage of funds with sector asset class exposure over…		
Sector	**Number of funds**	**Average**	**Median**	**>85%**	**>90%**	**>95%**
Asia Pacific Excluding Japan	98	93	94	95	74	40
Asia Pacific Including Japan	7	94	96	100	71	57
China/Greater China	35	93	94	86	71	49
Europe Excluding UK	109	95	97	94	86	46
Europe Including UK	51	95	95	96	88	51
European Smaller Companies	20	94	95	95	90	50
Global	259	95	97	92	87	69
Global Em. Markets	77	97	97	99	97	75
Global Equity Income	36	96	97	92	92	81
Japan	64	98	98	100	98	94
Japanese Smaller Companies	7	97	97	100	100	86
North America	124	95	97	97	89	67
North American Smaller Companies	10	95	96	100	80	70
UK All Companies	258	89	90	75	52	19
UK Equity Income	75	88	91	59	51	20
UK Smaller Companies	44	91	93	86	68	25

(Source: IA analysis based on Morningstar data)

91. Moreover, although the main purpose of the 20% is to allow flexibility, Table 4 shows that there is little variation in the average and median asset class exposure across years and remains generally close to 90%, thus indicating both a great degree of comparability and that they are subject to similar market risks.[223]

[222] Most recent available observations at the time of the analysis.
[223] Most funds across all sectors hold cash as part of their portfolio, typically between 2% and 4%. For UK All Companies the average allocation in cash is around 3%.

Table 4: Exposure to sector asset class for IA equity sectors, year-end 2012-2016.[224]

	Average (%)					Median (%)				
Sector	**2012**	**2013**	**2014**	**2015**	**2016**	**2012**	**2013**	**2014**	**2015**	**2016**
Asia Pac excl. Japan	94	92	92	94	93	96	93	93	95	94
Asia Pac incl. Japan	95	90	91	94	94	97	90	92	94	96
China	94	94	93	94	93	95	95	94	96	94
Europe excl. UK	95	94	93	94	94	96	96	95	95	95
Europe incl. UK	96	95	94	95	95	96	96	96	96	95
Europe Smaller Cos	95	94	95	94	94	96	95	95	95	95
Global	95	94	93	95	95	97	96	96	97	97
Global Em. Markets	96	96	95	97	97	97	96	95	98	97
Global Equity Income	96	96	95	96	96	97	97	96	98	97
Japan	98	98	98	98	98	98	98	99	98	98
Japanese Small Cos	98	97	97	97	97	98	98	96	97	97
N. America	93	93	95	95	95	94	94	96	96	97
N. America Small Cos	92	93	94	94	95	93	93	94	94	96
UK All Companies	89	92	92	91	89	90	94	94	93	90
UK Equity Income	87	89	88	88	88	89	91	89	90	91
UK Smaller Cos	90	90	91	92	91	90	91	92	94	93

(Source: IA analysis based on Morningstar data)

92. This is important in the context of the FCA discussion about active fund performance where it is stated that *"active funds are able to invest outside their benchmark; therefore excess returns against their benchmarks are not necessarily reflective of the risk taken on"*.[225] The IA too has considered the possibility of investing outside the benchmark being a driver of outperformance in its own analysis.[226] We concluded then as well that since funds across equity sectors invest on average well over 90% of their assets in their respective markets (as evidenced further in the above tables), investing outside the benchmark could only explain outperformance to a very limited extent.

93. Consequently, we would conclude that the sector classification is a reasonable reflection of risk, that the funds in the same sector are comparable in terms of investment in stated assets, and that investing outside the benchmark is low so that it is unlikely to drive outperformance.

6. 'Partly active' funds and indicative metrics

94. This section discusses the FCA finding that there is *"£109 bn in expensive funds that closely mirror the performance of the market"*[227] and the *"potential poor value for money for investors in such products"*[228]. We explore the wider 'partly active', or in ESMA's terms 'closet index tracker' debate, and argue that this is an area that is ultimately related to clarity of objectives and delivery against those objectives – factors that cannot simply be summarised in one figure such as tracking error or even active share.

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[224] Observations are year-end for 2012-2015 and November for 2016.

[225] Para 6.28, p.96.

[226] The Investment Association, *Investment costs and performance: empirical evidence of UK fund industry delivery*, August 2016.

[227] Para 1.27, p.16.

[228] Para 6.43, p.102.

Tracking error vs. outcomes

95. In regards to the FCA's analysis, Figure 6.5 in the Interim Report compares OCF to tracking error for active and passive funds and it is stated that *"there are a significant number of partly active share classes with substantially higher charges than equivalent passive products. Investors in these relatively expensive partly active products would likely achieve better value for money from switching to a cheap passive fund in the same investment category."*[229]

96. One key assumption for this statement to hold is that active and passive funds will produce the same outcomes – something that as discussed above, both the FCA and the IA analysis show is not the case. Moreover, it ignores other differences, e.g. the ability of investors in active funds to access particular company types, sectors, cash flow expectations etc. that are not available in passive products.

97. We have conducted further analysis with specific focus on the connection between tracking error and outperformance across active equity funds and then a comparison between active and passive funds. We used monthly net returns from January 2003 to December 2015 across all equity share classes (both bundled and clean) and then repeated that analysis only for the new primary clean share classes from January 2013 to December 2015. We took two performance measures both net of ongoing charges: excess return which is defined as the fund return minus the benchmark return and the CAPM alpha using the benchmark as the market portfolio. We used two different benchmarks: the Morningstar Category Benchmark and the Primary Prospectus Benchmark. As a robustness test we have calculated all combinations of performance measures and benchmarks and find very similar results. As such, we present here only the results for excess returns over the Primary Prospectus Benchmark as this is more relevant for investors.

98. Our analysis consisted of three different steps. In the first step, we sorted all share classes in two ways: in order of tracking error and in order of excess return. In each case, we split them into quintiles so that the first quintile (Q1) would have the group of share classes with the lowest tracking error or excess return values and the fifth quintile (Q5) the highest. In the second step we matched the tracking error quintiles with the excess return quintiles so that we could see how many share classes were in each pairwise combination (e.g. Q1 tracking error and Q1, Q2 etc. excess return). So for any given tracking error quintile this would show us the proportion that had low returns (Q1 and Q2 excess return quintiles) and the proportion that had high returns (Q4 and Q5 excess return quintiles). In the third step we calculated the average tracking error and excess return for each pairwise quintile combination.

99. Table 5 presents the results in three panels with the left column covering all active equity funds and the right column focussing on UK All Companies funds.[230] The top panel shows the proportion of share classes that are in each pairwise combination of excess return and tracking error quintiles. For example, we can see that 12% of share classes in the bottom (first) tracking error quintile were in the top (fifth) excess return quintile. The middle panel shows the average excess return for each combination of quintiles, so that the 12% identified above had an

[229] Para 6.42, p.101.
[230] We have repeated the same analysis across each equity sector, as well as for clean share classes only for 2013-2015, and results are similar.

average excess return of 4.73%. The bottom panel shows the average tracking error for each combination of quintiles, so that the same group of share classes had an average tracking error of 3.24%.

100. Putting all the components together, our example makes clear that low tracking error does not mean that a fund will underperform as 12% of share classes in the bottom tracking error quintile are in the top tracking error quintile with average excess return of 4.73%. At the same time, high tracking error does not guarantee outperformance. For example, looking at the 37% of share classes in the top tracking error quintile which were in the bottom excess return quintile, their average tracking error was high at 10.87% but they delivered an average excess return of -7.65%.

Table 5: Tracking error vs. excess return for active equity funds, 2003-2015

All active equity funds

Proportion of share classes in each quintile combination

	Tracking Error quintile				
Excess Return quintile	**Q1**	**Q2**	**Q3**	**Q4**	**Q5**
Q1	17%	14%	15%	18%	37%
Q2	29%	24%	17%	18%	12%
Q3	26%	25%	21%	19%	9%
Q4	16%	21%	29%	22%	12%
Q5	12%	16%	18%	23%	30%

Average Excess Return (in %)

	Tracking Error quintile				
Excess Return quintile	**Q1**	**Q2**	**Q3**	**Q4**	**Q5**
Q1	-3.55	-4.04	-4.28	-4.75	-7.65
Q2	-1.53	-1.49	-1.52	-1.57	-1.58
Q3	-0.16	-0.12	0.01	-0.08	-0.11
Q4	1.46	1.51	1.47	1.57	1.55
Q5	4.73	4.92	4.70	5.35	7.25

Average Tracking Error (in %)

	Tracking Error quintile				
Excess Return quintile	**Q1**	**Q2**	**Q3**	**Q4**	**Q5**
Q1	3.34	4.45	5.41	6.67	10.87
Q2	3.33	4.44	5.37	6.52	10.05
Q3	3.36	4.46	5.39	6.57	10.20
Q4	3.28	4.46	5.36	6.50	9.97
Q5	3.24	4.48	5.42	6.60	10.55

Active UK All Companies funds

Proportion of share classes in each quintile combination

	Tracking Error quintile				
Excess Return quintile	**Q1**	**Q2**	**Q3**	**Q4**	**Q5**
Q1	17%	25%	13%	15%	31%
Q2	37%	23%	17%	15%	8%
Q3	22%	17%	30%	20%	10%
Q4	11%	14%	25%	30%	20%
Q5	14%	21%	16%	19%	30%

Average Excess Return (in %)

	Tracking Error quintile				
Excess Return quintile	**Q1**	**Q2**	**Q3**	**Q4**	**Q5**
Q1	-2.81	-2.62	-3.58	-3.32	-6.94
Q2	-0.75	-0.69	-0.73	-0.72	-0.77
Q3	0.46	0.59	0.64	0.78	0.54
Q4	2.19	2.08	2.22	2.34	2.19
Q5	5.13	6.01	4.80	5.32	6.11

Average Tracking Error (in %)

	Tracking Error quintile				
Excess Return quintile	**Q1**	**Q2**	**Q3**	**Q4**	**Q5**
Q1	3.42	4.52	5.26	6.31	10.00
Q2	3.30	4.45	5.19	6.15	9.12
Q3	3.36	4.59	5.38	6.28	8.49
Q4	3.28	4.49	5.27	6.26	9.10
Q5	3.28	4.45	5.29	6.32	9.11

(Source: IA analysis based on Morningstar data)

101. This indicates that tracking error is not necessarily indicative of outcomes. To get more clarity on this, we compared the average excess return per tracking error quintile between active and passive funds. Table 6 shows that active funds in the bottom tracking error quintile have a similar average tracking error (3.32%) as the passive funds in the fourth tracking error quintile (3.25%). They produce however very different outcomes with active funds having an average

excess return -0.25% compared to an average excess return of -0.63% for passive funds. At the same time, active funds in the second tracking error quintile have a similar average tracking error (4.46%) as the passive funds in the top tracking error quintile (4.92%) but they produce an excess return of 0.14%, i.e. they outperform their benchmarks, while passive funds underperform by -0.72%.

102. We see a starker difference within the UK All Companies sector where for example if we compare the average excess return for active funds in the second tracking error quintile (4.50% tracking error) to that of passive funds in the fifth tracking error quintile (4.55% tracking error) we see that the former outperform by 0.85% while the latter underperform by -0.34%.

Table 6: Average outperformance by tracking error quintile for active and passive equity funds, 2003-2015

All equity funds

Active			Passive		
Tracking Error quintile	**Average Excess Return in Tracking Error quintile**	**Average Tracking Error in quintile**	**Tracking Error quintile**	**Average Excess Return in Tracking Error quintile**	**Average Tracking Error in quintile**
Q1	-0.25	3.32	**Q1**	-0.29	0.19
Q2	0.14	4.46	**Q2**	-0.63	1.43
Q3	0.42	5.39	**Q3**	-0.32	2.63
Q4	0.43	6.57	**Q4**	-0.63	3.25
Q5	-0.65	10.50	**Q5**	-0.72	4.92

UK All Companies funds

Active			Passive		
Tracking Error quintile	**Average Excess Return in Tracking Error quintile**	**Average Tracking Error in quintile**	**Tracking Error quintile**	**Average Excess Return in Tracking Error quintile**	**Average Tracking Error in quintile**
Q1	0.28	3.33	**Q1**	-0.29	1.21
Q2	0.85	4.50	**Q2**	-0.39	2.81
Q3	0.93	5.29	**Q3**	-0.57	3.12
Q4	1.31	6.27	**Q4**	-0.57	3.36
Q5	0.12	9.32	**Q5**	-0.34	4.55

(Source: IA analysis based on Morningstar data)

103. The results of the above analysis are not consistent with the assertion that investors would achieve better value for money by switching to lower charging passive funds that have similar tracking error levels as active funds.

Closet index tracker debate

104. As discussed in Part Two of our main response, the FCA's point on 'partly active' funds seems to run parallel to the 'closet index tracker' work by ESMA.[231] The IA has considered in detail both the methodologies used to identify closet trackers and the extent to which these exist in the UK funds market.

105. The key problem with closet tracker funds relates to the connection between investment process, description of that process and level of fee, and whether investor expectations are

[231] ESMA, Supervisory work on potential closet index tracking, February 2016.

being created that cannot be met. As ESMA notes, this touches upon the broader issue of the *"effectiveness of investor disclosure"*. Regulatory requirements around fund disclosure are discussed in detail in Part Four of this response but regarding this specific issue the following applies:

- UCITS KIID Article 7.1 requires that *"the description contained in the 'Objectives and investment policy' section … shall cover those essential features of the UCITS about which an investor should be informed … including … (d) whether the UCITS allows for discretionary choices in regards to the particular investment that are to be made, and whether this approach includes or implies a reference to a benchmark and if so, which one; … where a reference to a benchmark is implied, the degree of freedom available in relation to this benchmark shall be indicated, and where the UCITS has an index-tracking objective, this shall be stated."*
- COBS 4.2.1, that communication should be fair, clear and not misleading would be breached if communication describes an active and/or benchmark unconstrained approach to investment management where this is not the case.

106. In spite of these regulatory requirements, there are concerns about the scale of closet indexing in the European funds industry. ESMA used three metrics to identify potential closet trackers: R-squared, tracking error and active share. It is necessary to explore these in more detail as feedback is invited on methodologies for estimating how active a fund is.[232]

107. R-squared is obtained through regressing fund returns on benchmark returns and is the proportion of variance of fund returns explained by the benchmark returns. Since it is a regression on just one variable, R-squared is also the correlation between fund and benchmark returns squared. As such, it reflects correlation of returns and not how close the fund holdings are to benchmark holdings.

108. Tracking error is the standard deviation of the difference between fund return and benchmark return. If the fund is close to the benchmark its returns will move in a similar way and hence the difference will be stable (low tracking error). Like R-squared, it reflects the correlation between the fund and the benchmark but does not give any indications about the similarity of holdings. Moreover, it is important to note that it reflects the volatility of the excess return rather than the actual level of excess return.

109. Active share is calculated as one half of the sum of the absolute differences between each of portfolio weights of the fund holdings and their corresponding weights within the benchmark portfolio. If the composition of a fund is identical to that of the benchmark, active share will be 0. If there is nothing in common, active share will be 100. Active share can be more than 100 when there are short positions in the portfolio. Contrary to R-squared and tracking error that reflect correlation between returns, active share actually looks at the similarity of holdings.

110. By definition, there is one significant complication that arises when the three metrics are used together and this relates to R-squared and tracking error being calculated over a period of time whereas active share can only be calculated for a single point in time. In such analysis, this is an

[232] Para 6.45, p.103.

issue that needs careful consideration not least because a single point in time cannot indicate how positions have changed between calculation points depending on investment opportunities and changing market conditions.

111. Interestingly, tracking error has been traditionally used in the institutional market but because active share is more intuitive and easier to understand, there has been increasing awareness of it and its potential usefulness as a tool for retail investors.[233] Even so, there are several issues that arise for an analysis that relies only on these three metrics.

112. First, none of the three provides information about performance and risk levels. We looked at tracking error and its connection to outcomes above but as an extreme example, one could consider a fund that is consistently outperforming the benchmark by the same amount each month. Since this amount of excess return would not vary, tracking error would be 0. High active share means a low degree of similarity of holdings and/or portfolio weights with the benchmark but it does not show how the fund has performed compared to a benchmark.

113. Second, all three metrics can only be calculated using an index as benchmark. This has two implications. For one, although it seems a straightforward exercise for equity funds, it would appear to be more challenging for funds that don't have a reference benchmark, funds that are benchmarked but not against an index (for example, if they use peer performance or cash benchmarks) or funds where tracking an index is not always feasible, for example, property or fixed income funds (the latter having implications for multi-asset funds that allocate into fixed income as well). This is particularly important as there seems to be no common approach on how to treat these funds.

114. At the same time, even for equity funds, one needs to consider the choice of benchmark. For active share, in particular, there is research showing that it is easier to achieve a high active share figure with a benchmark index that has many constituents and/or low concentration.[234] Additionally, as high active share means large deviation from the index, it could imply larger potential to outperform, larger potential to underperform, or that the selected index is becoming increasingly irrelevant.

115. Third, although for analytical purposes some thresholds need to be set, it is not clear to what extent these should be taken at face value. For example, it is questionable that a tracking error of 3.1% should be viewed as good but 2.9% as bad, just as it is questionable whether active share of 61% should be considered good but 59% bad.

116. Particularly for active share, the 60% threshold first appeared in the Cremers and Petajisto research on the basis that no more than half of stocks can beat the market and so an active share of less than 50% will always be a *"hybrid between a purely active and purely passive portfolio"*.[235] Subsequent research notes that the 60% cut-off point is *"somewhat arbitrary"*

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[233] Morrison C., *Active share: key insight or flawed measure?*, CFA Institute, 2016.
[234] For example see: Brandes Institute and SEB Investment Management, *Is your portfolio's 'high active share' really high?*, 2015; Fidelity, *Active share: a misunderstood measure in manager selection*, February 2014; Lazard, *Taking a closer look at active share*, June 2014.
[235] Cremers and Petajisto, *How active is your fund manager? A new measure that predicts performance*, March 2009.

and it is still used based on the same argument.[236] This seems to have been adopted by ESMA on the basis that it is used in academic research and by consumer organisations.

117. There is a complication when funds with different investment types are judged against the same threshold. Domestic markets in different countries vary in maturity, have different levels of concentration and present different opportunities to invest outside a benchmark. Applying the same threshold over all of them make funds invested in specific markets seem more 'active' without this fully reflecting the investment style.

118. With few notable exceptions, there has been very little discussion on both the merit of a cut-off point and the appropriateness of setting it at 60% (or even 50%). The need for more careful consideration is evident in other aspects of active share as well.[237] The very limited applicability across non-equity and multi-asset funds has already been discussed above in the context of needing to have one index (that can be tracked) as a benchmark. There is also the aspect of how to account for exposure to an index which cannot be captured by active share such as through ETFs, derivatives, and other funds. Moreover, cash is held by funds as a strategic decision but it would still increase active share as it is never an index constituent.

119. The IA has tried to replicate ESMA's analysis for funds sold in the UK using the same criteria as ESMA but with the additional restriction that funds also had to be classified within one of the IA equity sectors. We used monthly net returns and each fund's reference benchmark (primary prospectus benchmark) to calculate the three metrics. All data was sourced from Morningstar.

120. The sample initially had 656 equity funds but due to lack of return data and by excluding funds that did not have an index as reference benchmark, the end-sample consisted of 548 equity funds. Of these, only 27 had active share below 50%, tracking error below 3% and R-squared above 95%. And only half of these had a negative alpha net of fees. Considering other factors besides performance such as management fee and active share figures over several years, resulted in only a handful of funds that would still merit further attention to assess whether an issue existed with respect to investor literature and how investment objectives are communicated.

121. Ultimately, using a methodology based on (each of) these three metrics can flag potential closet trackers but cannot serve as conclusive evidence. A closet index tracker will have high R-squared and low tracking error and low active share. However, a high R-squared, low tracking error and active share are not enough to identify a closet index tracker and they can only be used as indicators of a potential issue rather than as a means to bypass detailed and thorough fund-by-fund analysis with specific consideration of investment objectives and delivery.[238] This point is explicitly acknowledged by ESMA that notes its statistical analysis *"can only be a first step in the investigation of closet indexing"*. And in this context, the issue is not whether tracking error (or any metric) is above or below a specific threshold but what outcome has been achieved and to what extent both the investment strategy and the delivery correspond to the investment objective that has been communicated to investors.

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[236] Cremers, Ferreira et al, *Indexing and active fund management: international evidence*, February 2015.
[237] Gillman B., *Active share is a fuzzy number*, CFA Institute, March 2016.
[238] Akin to the type of analysis the FCA carried out in its Thematic Review TR16/3 on meeting investors' expectations.

122. As we discuss in Part Four of our response, the IA is keen to work with regulators to ensure that an accessible and dependable framework emerges to help consumers understand investment fund investment objectives and delivery. The technical analysis described above is designed to find effective ways to facilitate this. We believe that a combination of narrative and metrics may be the way forward and will be undertaking further work in this area, including on language.

ANNEX TWO: BOX MANAGEMENT

1. This Annex sets out the interaction of the unit prices used in dual pricing, the protection provided to the investors in the fund and the role that box management plays. It is intended to be read alongside Box 7.2 of the Interim Report, which does not provide a complete account of how box management operates.

2. In its simplest form dual pricing operates with two prices: the issue price and the cancellation price which reflect the full costs of buying and selling underlying investments respectively[239]. The issue and cancellation prices represent the costs of creating or cancelling fund units; mechanisms by which the manager is able to expand or shrink the fund in response to investor demand. In the absence of a box these would be the only prices at which investors could join or leave the fund. These are the prices at which it is fair to other investors for new investors to join the fund and for existing investors to withdraw.

3. The manager's box is a mechanism whereby the manager is able to match investors' transactions and carry a stock of units in order to reduce the need to issue and cancel units. For example, if the manager sells more units than it holds in stock or obtains from redemptions, it will be necessary to issue additional units. Operating the box reduces the need to issue these units, and consequently avoids the need to buy underlying investments. The benefits of this can accrue either to the manager and/or the incoming and outgoing investors. This is because the ability to match units in this way allows the manager to sell and redeem units at prices that are preferential[240] to the transacting investors with no detriment to the fund itself.

4. The bid-offer spread of the units is the result of a view taken about the management of risk. In order to provide investors with access to beneficial dealing terms the manager takes on both market risk and liquidity risk. The manager faces market risk in proportion to the stock of units it holds which can increase or decrease in value. The manager faces liquidity risk if it has to issue units at a higher price than the units it has sold (or cancel units at a lower than redemption price). There are a number of approaches used to manage and mitigate these risks. For example, running a very small stock of units will minimise market risk but will increase liquidity risk due to a reduced ability to absorb mismatches in investor flows.

5. The liquidity risk may be managed by aiming to set a bid-offer spread sufficient to cover the cost of issuing or cancelling units in response to net inflows or outflows. The most appropriate size of this spread (which may be considerably smaller than the full spread) depends on the balance of unpredictable inflows and outflows. If the approach taken is to set a spread sufficient only to mitigate liquidity risk (which aims to share the full benefit of matching with transacting investors) the consequence of unpredictable flows will be incidental box profits or losses.

6. Alternatively, the FCA handbook allows managers to eliminate this liquidity risk by operating at a full spread; that is, only selling units at issue price and only redeeming units at cancellation price.

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[239] For the purpose of this Annex we assume there is no initial charge applied to the offer price.
[240] Prices are preferential when investors can buy units at an offer price below the issue price or redeem their units at a bid price higher than the cancellation price.

This leaves transacting investors in exactly the same position as if there was no box, but it also facilitates risk free box profits. The FCA has approved this approach since the FCA Handbook acknowledges that managers can operate a box *"with the principal aim of making a profit"* COLL 6.2.9 G (4).

7. At a technical level, whether the manager's box is operated for profit or as an investor service to provide investors with a mechanism to buy or sell units at a better price than would otherwise be possible, the fund itself is never disadvantaged compared to the situation in which no box is operated. Box management is an exercise in sharing the benefits of matching units between incoming investors, outgoing investors and the manager itself. In providing this service the manager is exposed to market and liquidity risk which means it is not necessarily a risk-free activity. However, it is important to recognise that to pay box profits into the fund artificially enhances the performance track record. Therefore, new rules would need to address the way in which the box is operated.

8. Dual pricing is the most sophisticated and effective method of sharing the benefit of matching units with transacting investors. It is the only method[241] where the benefit can be shared by both incoming and outgoing investors and at the same time ensuring existing investors in the fund are fully protected from dilution. If the FCA considers it necessary to change the rules to eliminate risk-free box profits, care should be taken not to deprive investors in dual priced funds of the potential benefits of box management or to distort performance comparisons. For example, the FCA could specify that a bid-offer spread cannot be applied for the purpose of creating a profit or avoiding a loss (this can be evidenced by the relationship between historical flows and the spread) – this is the approach taken in legislating for swinging pricing in COLL 6.3.8 R (5). Moreover, the FCA could require disclosure in the prospectus of the spread as an anti-dilution measure in a manner consistent with that required for dilutuion adjustments and dilution levies.

[241] Partially swinging single pricing accommodates both incoming and outgoing investors sharing the matching benefit only if some dilution is passed into the fund. If full protection from dilution is provided via fully swinging single pricing, the matching benefit can only accrue to either incoming or outgoing investors, but not both.

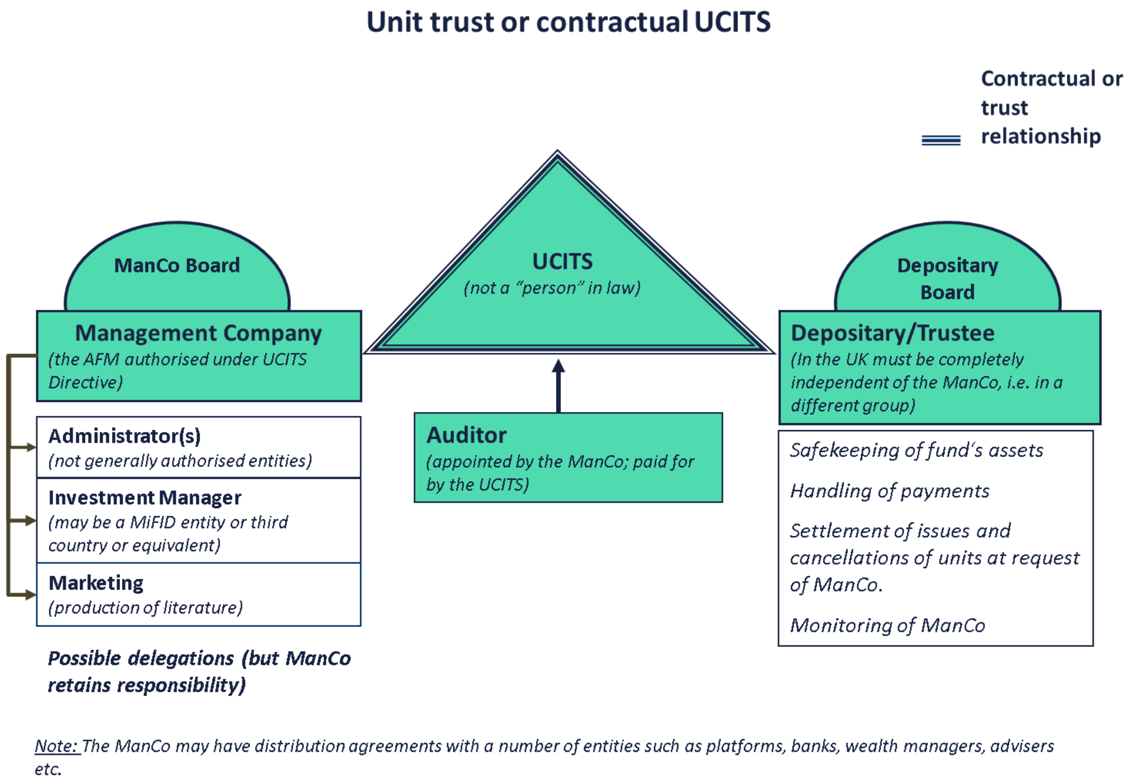
ANNEX THREE: FUND GOVERNANCE STRUCTURES

1. A key focus of our technical work on fund governance has been the practical and consistent application of universal remedies to the very different legal structures of OEICs, unit trusts and authorised contractual schemes (ACS). This Annex provides an overview of these legal structures and relevant considerations. We would welcome further engagement with the FCA on how a structural change would be implemented should that path be one which the Final Report recommends.

2. Figure 1 below shows a UK authorised fund that is structured as a unit trust. These are constituted by a deed between the authorised fund manager (AFM) – the Management Company (ManCo) – and the trustee which is the depositary in regulatory terms.

3. The boards of both the ManCo and trustee/depositary are shown. These contrast with the unit trust which is not a corporate, nor indeed, a legal person. In terms of governance of a trust, the trustee role is the usual place for governance/responsibility to sit, but regulatory overlays on the classic trust structure impose a series of responsibilities upon a fund manager, which itself like the trustee, need to be carried on by an authorised person.

Figure 1: Governance structure of unit trusts or contractual UCITS[242]



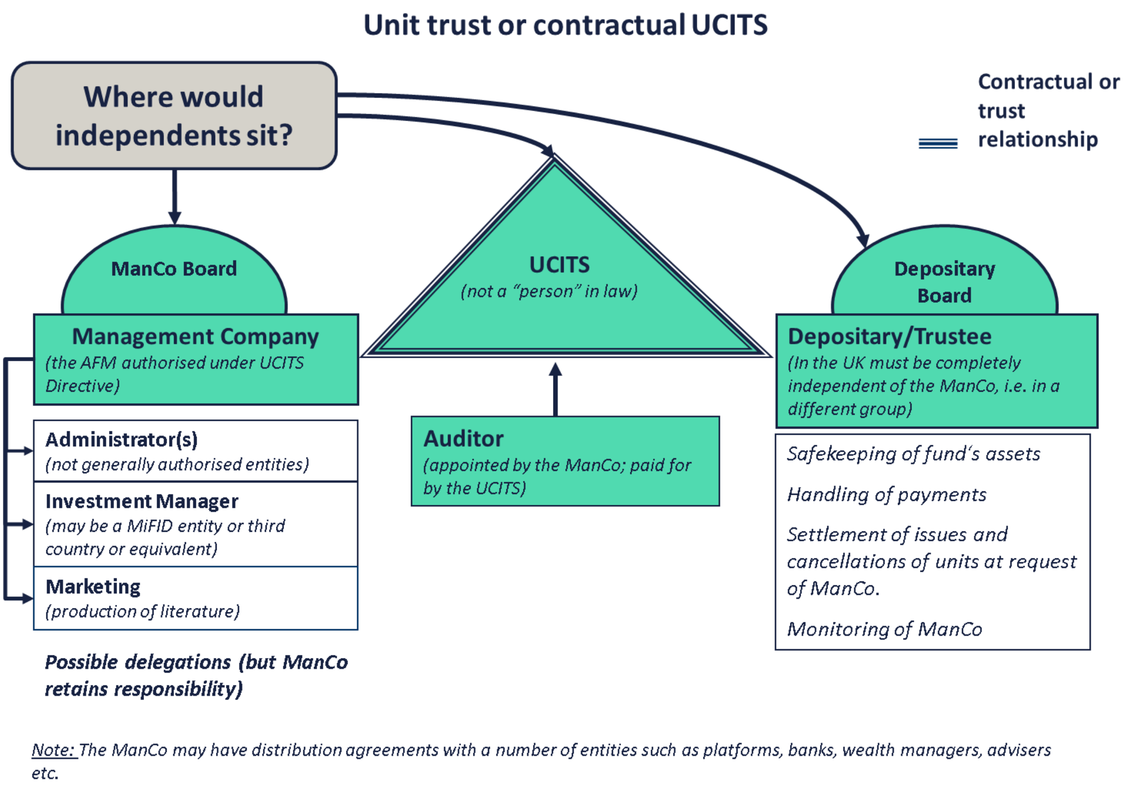
4. We highlight in Figure 2 the three places where an independent challenge function, or independent officers, might be located in the structure shown above. The arrow to the trust

[242] An ACS has a similar structure to a unit trust although is established under contractual law rather than trust law.

itself is unprecedented, since that would appear in general law to imply that the function was acting as a trustee (which already exists in this model in the form of the corporate trustee/depositary). As we set out in Part Five of our response, we would also question whether overlaying additional obligations upon the corporate trustee/depository is appropriate given the commercial relationship with the fund. This focuses the options towards the AFM/ManCo levels in the absence of viable fund-level options.

5. One alternative (outside the legal structure) that has been used for Charity Authorised Investment Funds (CAIFs) is advisory committees. However, these do not have executive powers and their advisory status partly reflects the fact that a governing actor must be either a trustee or the AFM, and that any other role cannot have ultimate governance power.

Figure 2: Independence within governance structure of unit trusts or contractual UCITS



6. Figures 3 and 4 below depict in similar fashion a UK authorised OEIC (an ICVC). In this case, a board of the fund does exist. And whilst in all but a few cases the board consists of a sole director, the ACD, it does not have to do so under the OEIC regulations. That said, COLL 6.5.5 requires that such non-ACD directors take reasonable care to ensure that any ACD fulfils its duties in a competent manner.

7. Whatever the prima facie legal position of a unitary board of an OEIC, as is permitted by regulation 34(4)(b) of the OEIC regulations, the FCA rules impose different responsibilities and presently make the ACD the key, and pre-eminent actor. The ACD has responsibility for ensuring that the regulatory obligations imposed on the OEIC are complied with. The regulation of the present role of an independent director is effectively circumscribed by the role and duties allocated to the ACD. Our reading of the OEIC regulations suggests to us that the FCA would

have some flexibility to re-allocate responsibilities depending upon the conclusions of the Market Study Final Report about future direction of travel.

Figure 3: Governance structure of incorporated UCITS

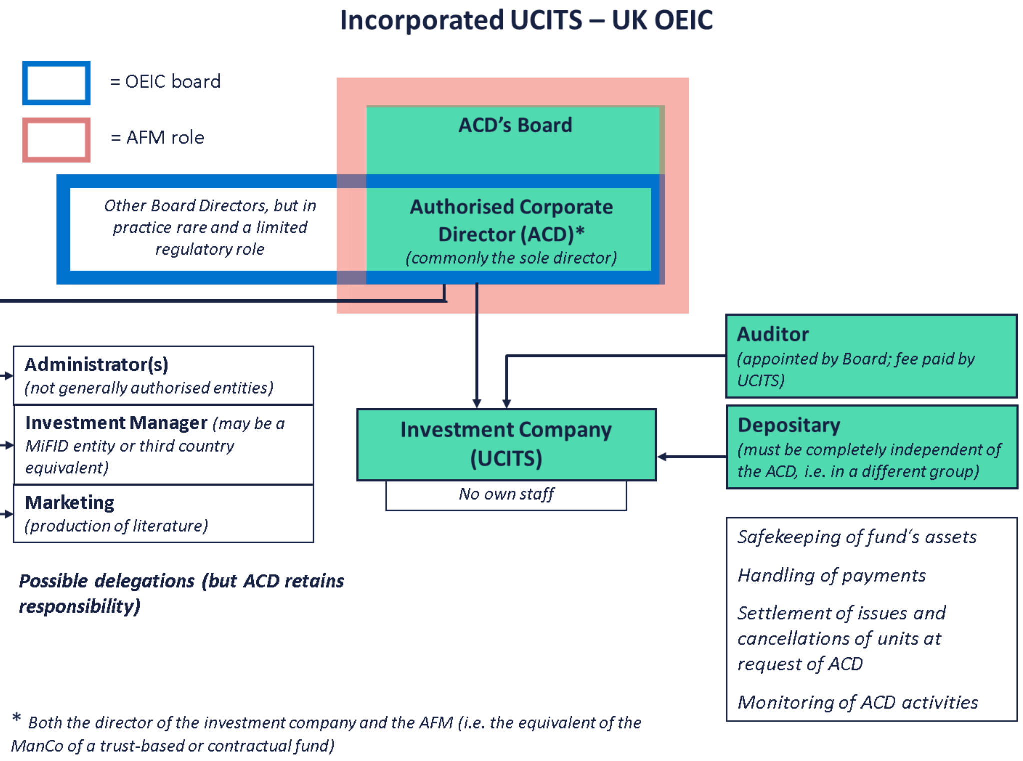
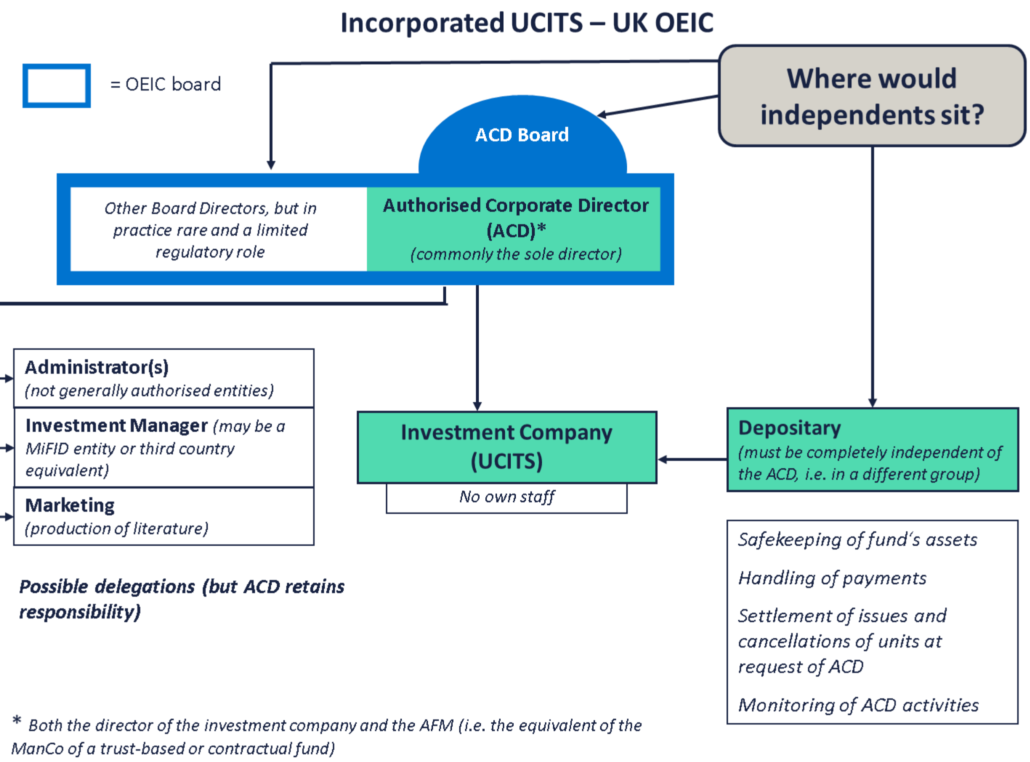


Figure 4: Independence within governance structure of incorporated UCITS



8. We note that European legislation permits the management of UK funds by non-UK EEA management companies, over whom FCA would not have the power to require certain corporate governance arrangements to apply at the level of the firm, as these would be within the competence of the management company's home state regulator. We also note that EEA funds passported into the UK can do so on the basis of regulatory requirements on fund governance in the country of domicile, not the country of distribution. As such, it seems that the FCA's proposed corporate governance requirements should avoid introducing a non-level playing field between funds domiciled in the UK and those domiciled elsewhere.

9. Figures 5 and 6 show examples of Incorporated Fund structures in other jurisdictions, one with no management company and one with a management company. In both cases, rather than have an ACD, the Board of Directors consists of individual directors. These demonstrate how the corporate structure used in other jurisdictions is very different and rather reflects the usual corporate structure.

Figure 5: Governance structure of incorporated fund with no management company

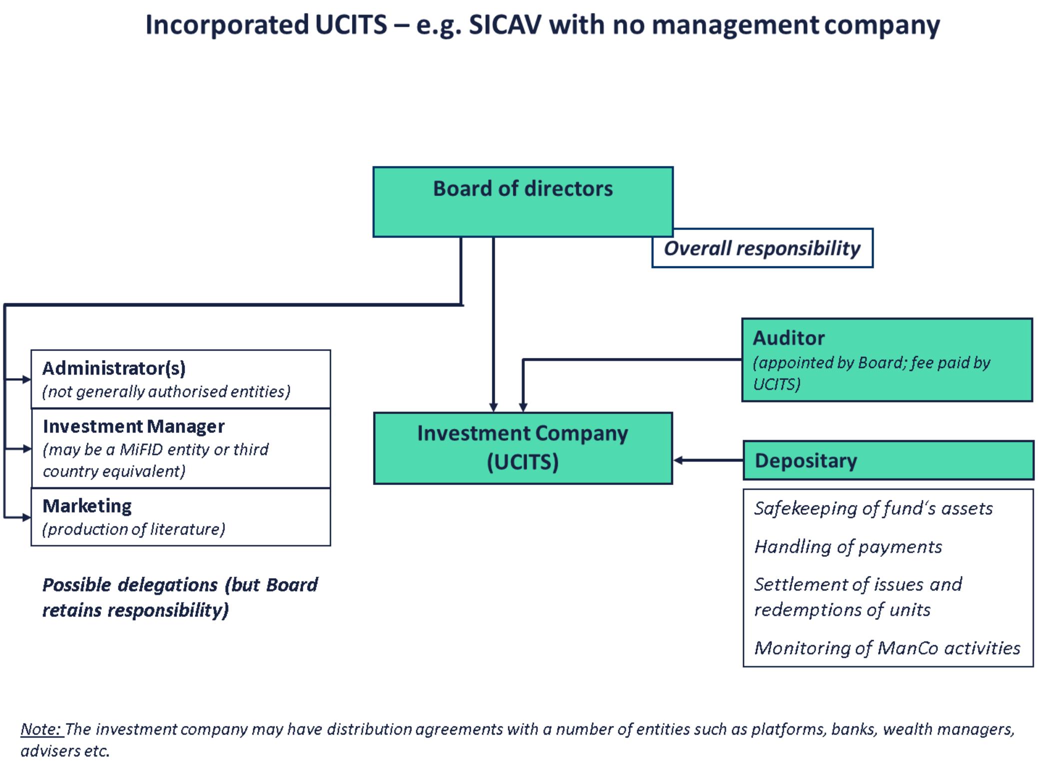
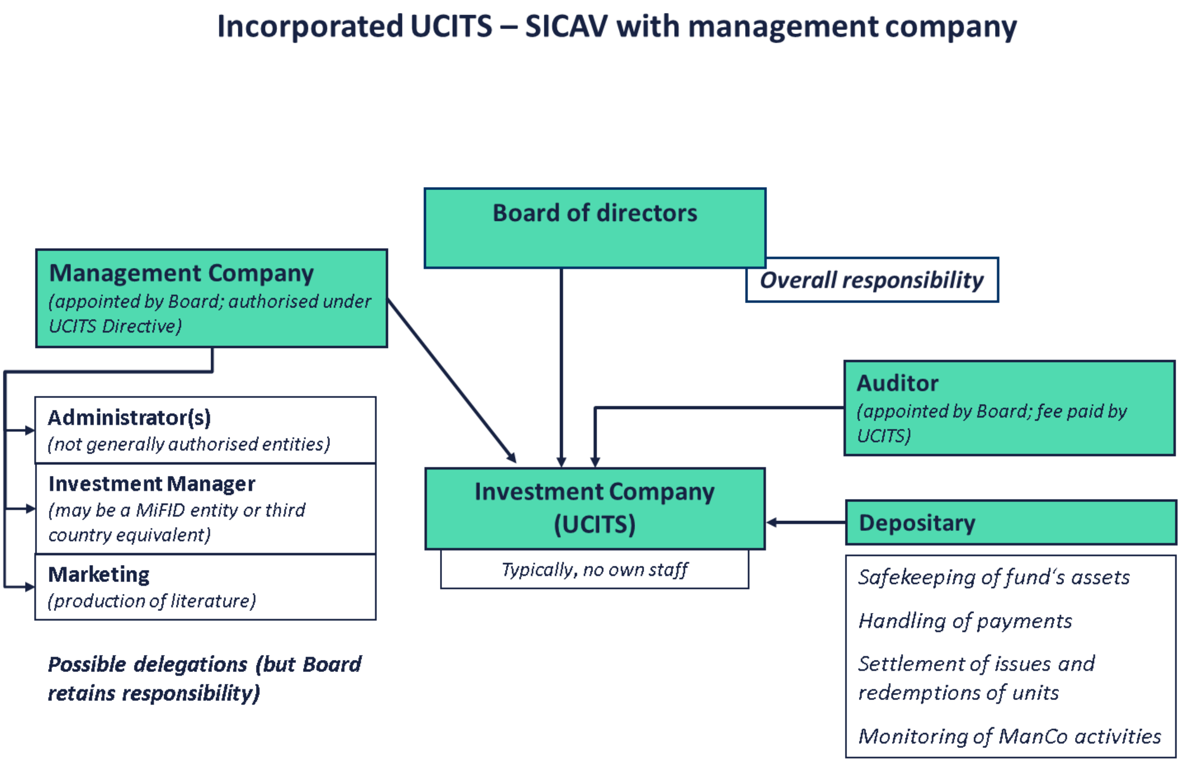
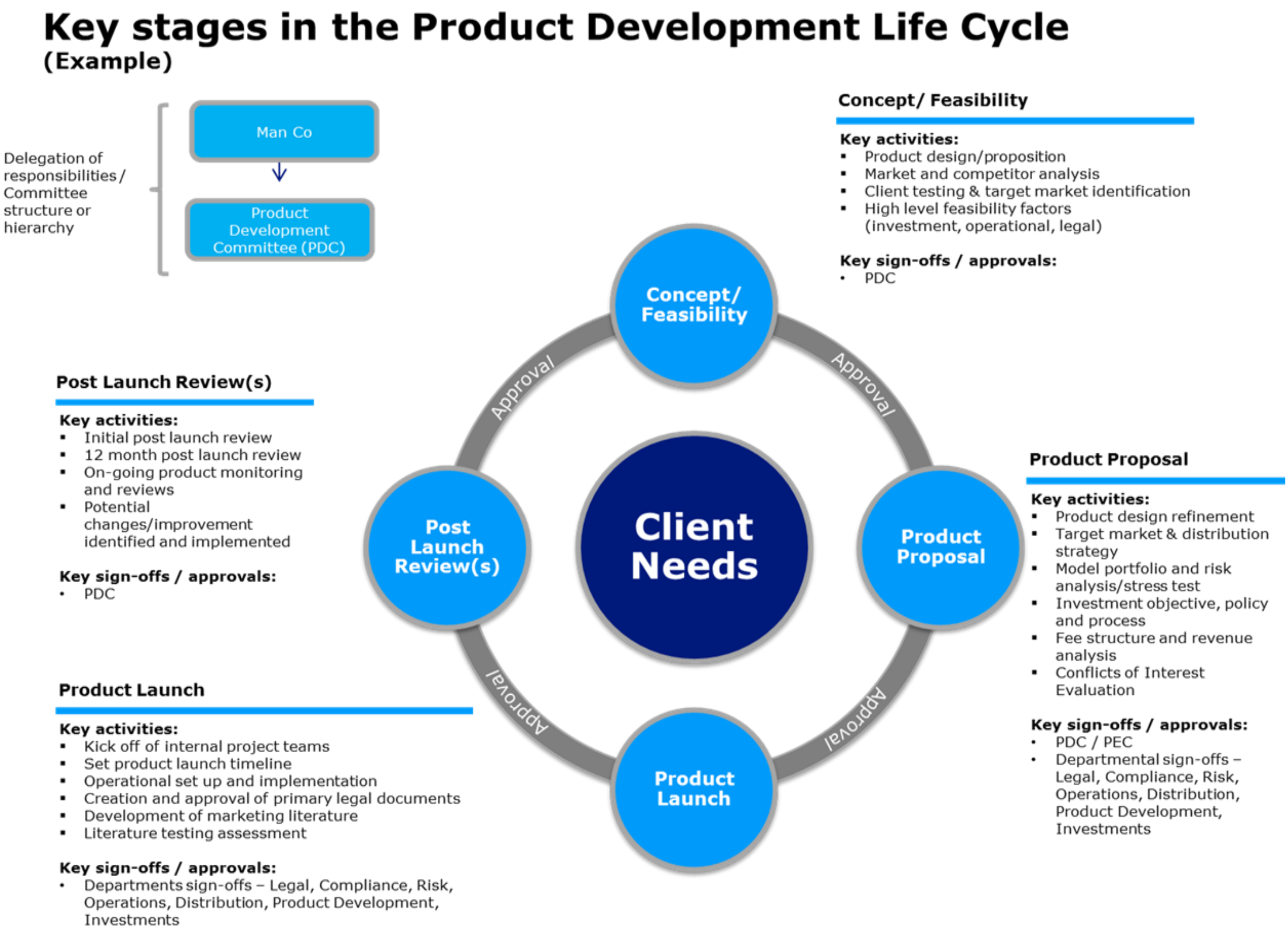


Figure 6: Governance structure of incorporated fund with management company



ANNEX FOUR: KEY STAGES IN THE PRODUCT DEVELOPMENT LIFE CYCLE



ANNEX FIVE: IA DISCLOSURE CODE TEMPLATES

Segregated Mandate Cost Disclosure Template

SEGREGATED MANDATE COST COLLECTION TEMPLATE *For use with segregated portfolio management mandates*

All figures are monetary amounts unless specified

Asset Manager				
Portfolio name				
Period of report	Start:		End:	
Currency of report	GBP			

Investment return	**1 year**	**3 years**	**5 years**	**10 years**	**Since formation**
Gross return (% pa)					
Net return (% pa)					

Investment activity	**Total**	**Equity**	**Bonds**	**Property**	**Pooled funds**	**Other (specify)**
Opening assets						
Closing assets						
Purchases	0					
Sales	0					
Turnover (% pa)	%					

Management fees	**Total**
Invoiced fees (less rebates)	
VAT (if applicable)	
Payments for research	
Other charges (specify)	
Performance fees	
Total	**0**

Indirect fees	
Fees paid from NAV of pooled funds	

Transaction costs	**Total**	**Equity**	**Bonds**	**Property**	**Pooled funds**	**Derivatives**	**Foreign exchange**	**Other (specify)**
Transaction taxes	0							
Broker commission	0							
Implicit costs	0							
Entry/exit charges	0							
Indirect transaction costs	0							
Other transaction costs (specify)	0							
Total	**0**	0	0	0	0	0	0	0
Transaction costs per value traded								

Stock lending (if applicable)		
Value of stock on loan		%
Gross income		
Less: income shared (name recipients)		%
Income retained by client	**0**	%

Ancillary sevices (if provided by manager)	
Custody charges	
Collateral management	
Other (specify)	
	0

Pooled Fund Cost Disclosure Template

POOLED FUND COST COLLECTION TEMPLATE

For use with investments in pooled funds

All figures in % of average NAV pa unless specified

Fund Manager	
Fund name	
Share class name	
Date of report	
Currency of report	GBP

Investment return (% pa)	**1 year**	**3 years**	**5 years**	**10 years**	**Since formation**
Net return					

Investment activity (GBP unless specified)	**Total**	**Equity**	**Bonds**	**Property**	**Pooled funds**	**Other (specify)**
Opening assets						
Closing assets						
Purchases	0					
Sales	0					
Turnover (% pa)	%					

Management fees	**Total (GBP)**
Invoiced fees (less any rebates)	
VAT (if applicable)	
Total	0

Client-specific data	**Client (GBP)**	*To be completed by the investing client in order to calculate client-specific amounts*
Average value of client holding		

Ongoing charges	**Client (GBP)**	**Total**
Managers fees		
Other fees		
Indirect fees		
Total ongoing charges figure	0	0.00%

Performance fees	**Client (GBP)**	**Total**
Performance fees	0	

Transaction costs	**Client (GBP)**	**Total**	**Equity**	**Bonds**	**Property**	**Pooled funds**	**Derivatives**	**Foreign exchange**	**Other (specify)**
Transaction taxes		0.00%							
Broker commission		0.00%							
Implicit costs		0.00%							
Entry/exit charges		0.00%							
Indirect transaction costs		0.00%							
Other transaction costs (specify)		0.00%							
Anti-dilution offset		-0.01%							
Total transaction costs	0	-0.01%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

Stock lending (if applicable)	Total	
Value of stock on loan		%
Gross income		
Less: income shared (name recipients)		%
Income retained by pooled fund	**0**	%